In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, PETITIONER

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, PETITIONER

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Supreme Court of the United States

No. 72-486

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v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

ORDER ALLOWING CERTIORARI. Filed December 4, 1972.

The petition herein for a writ of certiorari to the United States Court of Appeals for the District of Columbia Circuit is granted. The case is consolidated with No. 72-488 and a total of one hour is allotted for oral argument.

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No. [illegible]

[illegible] Power Commission, Petitioner

v.

[illegible] Power Commission, Respondent

No. [illegible]

[illegible] Power Commission, Petitioner

v.

[illegible] Power Commission, Respondent

On Petitions To Review an Order of the
Federal Power Commission

JOINT APPENDIX

IN THE

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 24,517

MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioner*

v.

FEDERAL POWER COMMISSION, TEXAS GAS TRANSMISSION CORPORATION, and TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION, ET AL., *Respondents*

No. 24,632

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *Petitioner*

v.

FEDERAL POWER COMMISSION AND TEXAS GAS TRANSMISSION CORPORATION, *Respondents*

On Petition To Review an Order of the Federal Power Commission

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JOINT APPENDIX

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EXCERPTS FROM TRANSCRIPT OF PROCEEDINGS

Presiding Examiner: Under the circumstances, I will rule that the proceeding will be tried in two phases, two phases for trial and decision.

In Phase 1 the issues of rate of return and related income

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tax will be tried, and the issue of the return from accelerated to straight line depreciation, insofar as the principle thereof is involved.

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Prepared Testimony of W. M. Elmer

Q. Please state your name and address. A. W. M. Elmer, 3800 Frederica Street, Owensboro, Kentucky.

Q. What is your present occupation? A. I am chairman of the board of directors and chief executive officer of Texas Gas Transmission Corporation.

Q. Please give your educational and business background. A. I received my college degree in 1936 from the University of Illinois. I am a certified public accountant. From 1936 until 1947, except for a period of service in the United States Navy, I was employed by Arthur Andersen & Co., public accountants and auditors. During this period, I did extensive consulting work for various utilities, and supervised the audit of the accounts of numerous utilities. In June of 1947, I was employed as the comptroller of Memphis Natural Gas Company, a predecessor of Texas Gas. When Texas Gas Transmission Corporation became an operating company in 1948, I became comptroller of that company. Subsequently, I served as treasurer, vice president, senior vice president, executive vice

president, and in 1957 I became president of the company. In 1968 I was elected to my present position.

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Q. Mr. Elmer, are you familiar with Mr. Meythaler's testimony relating to the reasons why Texas Gas is seeking permission to revert to a straight-line method of computing tax depreciation? A. Yes, I am.

Q. Do you know of any reasons, other than those described by Mr. Meythaler, which led the management of Texas Gas to seek permission to revert to a straight-line method of computing tax depreciation? A. I don't know any additional reasons. I would like to elaborate on

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several of the points which Mr. Meythaler has already covered.

Q. Will you please indicate the points to which you refer? A. I am referring to the changed circumstances which now confront the pipeline industry generally, and Texas Gas in particular, in comparison to the situations which existed at the time of the Commission's decision in the Alabama-Tennessee Case (31 FPC 208 1964).

Q. What are these changed circumstances? A. At the time of the Commission's decision in the Alabama-Tennessee case, which reversed its prior policy with respect to liberalized depreciation, there was no particular problem as to the availability of future gas supply or with respect to projecting future industry growth to meet the ever increasing demand for natural gas.

With respect to gas supply, the Commission, in Alabama-Tennessee, stated:

"We do not dispute the contention that economically extractable gas reserves will suffer exhaustion at some indeterminate future date. However, we knew of no re-

liable claim that such exhaustion of gas supplies is certain or even probable within this century. The fact that our gas reserves may be exhausted in the 21st century certainly does not establish that there is a present need for additional normalization." (p. 218)

With respect to future industry growth and investment in plant, the Commission stated:

"Almost all responsible forecasts reflect the widespread belief that the gas pipeline industry will continue to expand at least until 1980. . . . Senate Committee on interior and Insular Affairs, . . . concluded (at p. 37 of the Report) that the use of gas in 1980 will be somewhat less than doubled the 1960 usage and observed that the majority of the pertinent estimates clustered in the range between 20 and 23 trillion

cubic feet. * * * Although these estimates relate to gas consumption rather than to the capacity of gas pipeline plant, it is fair to infer that an approximate doubling of sales will generate a roughly proportional increase in plant investment." (pp. 217-218)

Today, however, the entire industry is faced with a very serious problem relating to the availability of natural gas reserves with respect to the expansion of service as well as service to existing markets. I feel that, with the assistance of the Federal Power Commission in its price fixing policies, the gas shortage problem can be alleviated.

On the other hand, I am also convinced that the problems involved in acquiring and providing long-term gas supply, on an economical basis, are much more serious today than existed at the time of the Alabama-Tennessee decision.

Q. Mr. Elmer, will you please indicate some of the problems to which you are referring? A. Yes. The cost of

natural gas today delivered to our pipeline is increasing rapidly and will continue to increase. The relatively low cost fields, from which gas was purchased years ago, are being rapidly depleted and must be replaced with higher cost gas. In the case of Texas Gas, our greatest potential supply area is under the waters of the Gulf of Mexico. The costs of exploring for and developing and producing this gas are continually increasing and will increase more so as the producer has to go into deeper and deeper waters. Coupled with this, off-shore gathering costs will also increase. Gas today represents approximately 60 percent of our revenue dollar. Therefore, in my opinion, the selling price of our product to the distributor and in turn his selling price to the consumer has

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only one way to go—up—not on a temporary, but on a long-term basis.

Today, natural gas has a marked competitive advantage over competing fuels in our service area. This is pointed out in Dr. Keyserling's testimony. On the other hand, the principal competitor, electricity, is not faced with long-term increases in costs to the same degree as the gas industry. I am of the opinion that in not too many years our competitive price advantage will be narrowed to the point where we will be fighting to compete, price-wise, with electricity.

The competitive fuel problem must be considered in the light of what might be considered realistic possibilities in the future. We already know, for example, that there are substitutes which can be, and probably will eventually be, developed for natural gas as we know it today. The two substitutes most widely discussed today are the gasification of coal and the importation of liquefied natural gas. I have studied both of these carefully. I know that both can be done, but I also know that, based upon the present

state of technology, the price will be so high that it will be difficult for us, by mixing either of the two with natural gas, to compete with electric energy. This is not just a theory. I am sure that anyone looking at the long-term potentials of gas requirements and the long-term gas availability studies will agree with my conclusions. So, here again, even though we may feel that we can keep our pipelines full, I am convinced that using one or more of these high cost substitutes will result in severe competitive problems.

If we lose our present price advantage by having to supplement our natural gas supply with gasified coal or imported LNG, no one can deny

that it can have a significant impact upon our growth potential. Therefore, the facts today as to the growth potential of this industry are, in my opinion, substantially different than they were when Alabama-Tennessee was decided.

Q. Does that complete your testimony with respect to the changed circumstances since the issuance of the Commission's decision in the Alabama-Tennessee case? A. No. There is one more point which is of significance.

Q. Will you indicate what this point is? A. On March 25, 1969 the Chairman of the Federal Power Commission, in testimony before the House Ways and Means Committee, recommended, on behalf of all five commissioners, that the privilege of utilizing the provisions of Section 167 of the Internal Revenue Code, relating to liberalized depreciation, should be withdrawn from natural gas pipeline companies and electric companies which are subject to the jurisdiction of the Federal Power Commission. This recommendation was made in complete recognition that the withdrawal of this privilege would require an increase in the rates of these utilities.

Q. What conclusions do you draw from these changed circumstances? A. It is difficult for me, as the chief executive officer of our company, to justify a continued use of liberalized depreciation, under present Commission policy of flow-through, in light of the problems which are facing the industry as to which I have just testified.

In addition, it makes no sense for Texas Gas to continue to use a method of tax depreciation as a basis of reducing the price of our

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product, at a time when we have a major competitive advantage. Under the Commission's present policy, we would be required to do just this and add a presently known and definitely ascertainable cost burden to future prices when our competitive advantage may have disappeared.

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Prepared Testimony of Virgil W. Meythaler
Re Exhibit Nos. 5 and 6

Q. Please state your name and business address. A. My name is Virgil W. Meythaler, and my address is 3800 Frederica Street, Owensboro, Kentucky 42301.

Q. By whom are you employed and in what capacity? A. I am employed by Texas Gas Transmission Corporation as Senior Vice President.

Q. Please outline, briefly, your educational and professional background. A. I was graduated from the University of Illinois in June of 1941 with a Bachelor of Science degree in Accountancy. Immediately upon graduation, I was employed by the accounting firm of Arthur Andersen & Co., and served on their accounting staff until July of 1942. From July of 1942 through 1945, I was on active duty as an officer in the United States Navy, after which time I returned to Arthur Andersen & Co., again being

on their utility staff until August of 1946. At that time, I accepted a position as Chief Accountant with Hart, Carter & Company in Peoria, Illinois. In 1947, I left this position to become Secretary and Treasurer of four small companies engaged in the manufacture, warehousing and sale of farm equipment. In this work, I was located in Rochelle and Monmouth, Illinois, and was responsible for all accounting

and financial matters of the companies. In 1948, I again entered the public accounting field as a Senior Accountant for the firm of Krieger and Stevenson in Peoria, Illinois. I remained with that firm until being employed by Texas Gas in May of 1949. In January, 1953, I was elected Assistant Treasurer and subsequently, have held the offices of Treasurer, Vice President and Treasurer. I have been a Senior Vice President of the company since 1961 and have been a member of the Board of Directors of Texas Gas since 1964. I am also one of four members of the Executive Committee and one of three members of the Finance Committee of the Board of Directors.

Subject to the Chairman of the Board of Directors, who is Chief Executive Officer of the company, I am responsible for all financial and accounting matters affecting the company. It is my responsibility to supervise studies as to the economic feasibility of proposed expansion programs as well as other capital expenditures and to make recommendations to the Board with respect thereto. I am responsible for making a determination of the amount and type of all new capital required by the corporation and its subsidiaries and for making final arrangements with respect thereto. I also maintain liaison with

investment bankers, insurance companies, security analysts and rating agencies in order to keep abreast of the cur-

rent cost of capital and market conditions. In this connection, it is my responsibility to maintain the financial integrity of the corporation as well as investor confidence in the securities of Texas Gas.

I have previously presented evidence, as a witness before the Federal Power Commission, in the following rate proceedings of Texas Gas: Docket Nos. G-2017, G-10751, G-12823 and RP61-15.

Q. What aspect of this proceeding do you propose to cover in your testimony? A. While I have a responsibility for the entire case, I propose to confine my testimony in this proceeding to four main subjects namely (1) rate of return (2) certain aspects of working capital, (3) the tariff changes relating to billing demands and (4) the reversion to straight line method of depreciation for tax purposes.

* * * * * * * * * *

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Q. Mr. Meythaler, I am now going to turn to the subject of tax depreciation. Would you therefore direct your attention to page 1 of Exhibit No. 8 (Statement H(3)) and indicate whether you are familiar with the data shown therein? A. Yes. I am familiar with these data.

Q. Will you state what method of tax depreciation was used in computing the Federal income taxes shown therein? A. In this proceeding, we are requesting permission to discontinue the use of liberalized depreciation and, in lieu thereof, to revert to a straight-line method of computing depreciation for tax purposes. Therefore, the Federal income taxes have been computed upon the assumption that this permission has been granted.

Q. Just what do you mean when you speak of reverting to a straight-line method of depreciation in computing income taxes? A. I mean that the Company proposes to elect to use straight-line depreciation on all new plant additions rather than liberalized depreciation as permitted

under Section 167 of the Internal Revenue Code. In addition, I also mean that the Company will discontinue the use of liberalized depreciation with respect to existing plant and, in lieu thereof, recoup the undepreciated balance of the original cost of such facilities, for tax purposes, on a straight-line basis over the estimated remaining life or lives of such property.

Q. What method does Texas Gas use, on its books, for determining

depreciation? A. We use a straight-line method.

Q. Will the amount of depreciation for tax purposes on existing plant on a reverted straight-line method, as you now propose, be less than the depreciation charged on the books of the Company for such property? A. Yes. This is because, under the double-declining balance method, the Company has utilized a greater amount of depreciation with respect to such property in the earlier years than is the case where a straight-line method is used. The former is the method which we have used in computing depreciation for tax purposes on depreciable transmission, storage, production and certain general plant. The latter is the basis upon which we accrue book depreciation on all of our plant.

Q. Is Texas Gas permitted, under the Internal Revenue Code, to discontinue the use of liberalized depreciation and revert to a straight-line method of depreciation for tax purposes? A. Yes. Under provisions of Section 167 of the Internal Revenue Code, if a company is utilizing the double-declining method of liberalized depreciation, it has the unqualified right to elect, at any time, to change to straight-line depreciation without permission from the Internal Revenue Service.

Q. When did Texas Gas first utilize liberalized depreciation for tax purposes? A. In 1955, the Company first began to utilize the double-declining

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method of depreciation as provided in Section 167 of the Internal Revenue Code of 1954 on certain of its depreciable plant, installed in 1955 and thereafter, as previously mentioned. On all other depreciable gas plant in service, we continued to use straight-line depreciation for tax purposes.

Q. Has Texaco Gas utilized accelerated amortization under Section 168 of the Internal Revenue Code? A. Yes.

Q. What method of accounting has been used relative to the use of accelerated amortization and liberalized depreciation? A. We use normalized tax accounting applicable to facilities constructed from 1953 to 1967, on which certificates from a defense agency permitted accelerated amortization. Under accelerated amortization, 25% of the cost of such facilities was amortized over a five-year period. The accounting is prescribed in the Uniform System of Accounts. Simply, it is charging "Provision for deferred income taxes, Account 410" and crediting "Accumulated deferred income taxes, Account 281" for an amount equal to that by which taxes payable for the year are lower because of the use of accelerated amortization of certified defense facilities in computing taxes, as compared to the depreciation otherwise appropriate, for tax purposes, on a straight-line method. After that portion of our certified facilities had been completely amortized, no depreciation for tax purposes could be claimed in subsequent years. Our accounting procedure was then reversed

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so that a charge to the accumulated reserve, Account 281, is made each year and a credit to "income taxes deferred in prior years, Account 411," in an amount equal to that by which taxes on income payable for the years are greater because of the use, in prior years, of accelerated amortization. The Company is presently amortizing this reserve

with an annual charge to Account 281 and a credit to Account 411 in the amount of $306,192 applicable to Federal income taxes.

As to the accounting used relative to liberalized depreciation, beginning in 1955 we followed normalization accounting which is similar to that which I have described in connection with accelerated amortization. It provided for charging "Provision for deferred income taxes, Account 410" and crediting "Accumulated deferred income taxes, Account 282," for the amount by which taxes payable for the year are lower because of the use of liberalized depreciation in computing taxes as compared to depreciation, for tax purposes, on a straight-line method. The prescribed accounting provided that for plant additions by vintage year for each class or group, when the tax depreciation was less than the straight-line depreciation because of having used liberalized depreciation, then the opposite accounting entries would be made charging Account 282 and crediting Account 411 to offset the higher tax payments.

This method of accounting was followed until October 1, 1966, at which time the Company, to comply with newly established

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policy of the Federal Power Commission, reduced its rates to "flow-through" the benefits of liberalized depreciation to its customers. Simultaneous with the rate reduction, Texas Gas adopted flow-through accounting which had the effect of flowing through, to income, the reduction in taxes attributable to the use of liberalized depreciation in each year rather than deferring this amount and accruing it in Account 283 as was done under normalization accounting.

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Q. Are you familiar with the reasons which led Texas Gas to propose, at this time, to revert to a straight-line

method of computing depreciation for tax purposes? A. Yes, I am. We reached this conclusion only after a great deal of study and consideration.

Q. Before discussing the reasons which led to this decision, would you first state, if you know, the reasons why Texas Gas initially decided to utilize liberalized depreciation? A. The Company originally decided to use liberalized depreciation only after the Federal Power Commission had declared that it would permit companies, subject to its jurisdiction, to normalize taxes for both accounting and rate-making purposes. Under this policy, Texas Gas would be receiving, in effect, an interest-free loan from the Government to the extent of the temporary reduction in taxes due to the utilization of liberalized depreciation. Initially, the Commission allowed a full return on facilities which

were financed with such funds. The Commission found that this was necessary in order to effectuate the intent of Congress, in enacting Section 167 of the Internal Revenue Code, to encourage the expansion and modernization of plant by all sectors of the economy, including public utilities. This Commission policy was subsequently affirmed by the courts, in all cases where it was questioned on judicial review.

Thus, the Company could take advantage of the same practices followed by all other industries in being permitted to utilize liberalized depreciation for tax purposes, thereby increasing its cash flow and making further expansion possible with less outside capital. Under this type of regulation, the Company could maintain its same level of rates and revenues as permitted prior to the use of liberalized depreciation and have additional funds as though receiving an interest-free loan from the Government. We recognized, that on any particular vintage plant, depreciation could only be taken to the extent of

100% of plant cost and that it was just a matter of timing as to when tax dollars would be paid. Under these conditions our Company's management decided to use liberalized depreciation on its major long-life depreciable plant additions.

Q. Was this policy subsequently modified? A. Yes, the Commission subsequently modified this policy by reducing the return on facilities constructed with such funds to 1½% but continuing the policy of permitting the normalization

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of taxes. The Commission found that, even at the reduced rate of return, the companies still had enough profit incentive to continue to utilize liberalized depreciation. This policy was affirmed on judicial review. While we were disappointed, we did agree that there was still an incentive to continue the use of liberalized depreciation.

Q. Was this latter policy ever modified? A. Yes. In the now famous Alabama-Tennessee case 31 FPC 208 (1964), the Commission, in a 3-2 decision completely reversed its prior policy by directing a flow-through, ratewise, of the current reduction in taxes due to the use of liberalized depreciation and, further, that no return would be allowed on the accumulated reserve for deferred taxes (Account 282). This policy was sustained on judicial review and has remained unchanged to the present.

Q. Would Texas Gas have originally elected to utilize liberalized depreciation if the Commission's policy had required "flow-through," as announced in the Alabama-Tennessee case? A. The answer is definitely "no" and I believe that our actions clearly answer this question. Although liberalized depreciation was permitted beginning with the tax year 1953, we did not utilize it until we filed our tax return, in 1956, for the calendar year 1955. Our reason for deferment was that the pipeline industry had

requested a declaratory order relative to the accounting and rate treatment to be accorded the use of

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liberalized depreciation which was not decided by the Commission until June 30, 1956. The management of Texas Gas was not willing to utilize liberalized depreciation until the Commission had declared its policy pursuant to the declaratory order which had been requested by the industry. Once the Commission had determined to permit normalization and full return upon the facilities installed with the funds generated through the utilization of liberalized depreciation, the management of Texas Gas concluded to use this method for tax depreciation. There is no question, however, that the Company would not have utilized liberalized depreciation if the Commission had, at that time, announced the policy which was subsequently set forth in its Alabama-Tennessee decision.

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Q. In your opinion, does the Commission's policy of flowing through the benefits of liberalized depreciation to the customer affect Texas Gas' ability to obtain funds for the expansion of its system to meet the increasing demands of its customers? A. Yes. Obviously, if the reduction in cost of service, attributable to the temporary reduction in taxes, is passed on, rate-wise, to the customer, such funds are not available for the construction of new facilities. This is particularly significant in a time, such as the present, where the cost of borrowed money is at an all time high.

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Q. Does the Commission's policy with respect to liberalized depreciation affect Texas Gas' ability to sell securities? A. Yes. Texas Gas, in flowing through bene-

fits of liberalized depreciation to its customers, had to reduce its rates, because of the Federal income tax effect, approximately $2 for every $1 of tax benefit. This reduction in revenues had the effect of reducing Texas Gas' "before taxes" coverage of interest and other charges.

Q. When Texas Gas reduced its rates to flow through the benefits of liberalized depreciation, what was the impact upon the coverages of Texas Gas? A. Our "before tax" coverage was reduced approximately 0.61 times and the "after tax" coverage approximately 0.12 times. Naturally, the impact on "after tax" coverage was not as severe as the dollar reduction was only equal at the loss of return and did not include loss of related tax dollars.

Q. What is the significance of the "before taxes" coverage to which you refer? A. For example, the two coverages which are shown in Moody's Public Utility Manual, which are material in determining the quality of a company's debt securities offered to the public, are the "before taxes" coverage and "after taxes" coverage. Of the two coverages, the "before taxes" coverage is the more important.

Q. Would you please explain why, if you know, the "before taxes"

coverage is more important? A. The "before taxes" coverage is the more important because it constitutes the total dollars available for the payment of interest, as interest has a prior claim on such dollars in that it is a deductible expense for tax purposes.

Q. Would the combined use of liberalized depreciation and flow through, affect Texas Gas' ability to sell securities? A. Yes, it would. For example, if we were to continue to use liberalized depreciation over the next three years instead of reverting to a straight-line method in computing taxes, our "before taxes" coverage would drop from the almost "3.5 times," which would be provided

by the proposed rates, to an average of merely "3.18 times." This, of course, would affect the quality of our securities. But, in addition, the reduction in revenues lowers the borrowing capacity of Texas Gas by more than $30,000,000, under coverage requirements in our Indentures.

Q. Is this one of the reasons which led Texas Gas to seek permission to return to a straight-line method of computing tax depreciation? A. Yes, it is.

Q. Are there any others? A. Yes. There are many, and they are all important.

Q. Will you please explain the other reasons. A. Of prime concern to Management in utilizing liberalized depreciation on a flow-through basis is the increasing taxes each

year without comparable increasing revenues unless major capital additions are made. No businessman today welcomes a built-in increase in costs. There are enough rising costs creating pressure on profit margins to cause grave concern without adding another when it could be avoided. For example, based on the gas plant in service used for the test period in these proceedings, the tax depreciation will decline from 1970 to 1971 over $1,100,000. Just to keep the same dollar differential between tax depreciation and book depreciation will require plant additions of almost $33 million. However, assuming that plant additions of $33 million would generate the same sales volume per dollar of investment as existing gross plant dollars provide, revenues from rates designed to flow through liberalized depreciation, computed today, would not be sufficient to recover the increased taxes as such rates would have been designed on a higher ratio of tax depreciation to book depreciation than would exist with only plant additions in the amount of $33 million. In order to maintain the same relationship which exists

today between tax depreciation and book depreciation, so that future revenues would recoup future tax costs, an expansion of approximately $41 million would be required. Even with this plant addition, Management cannot assume that additional revenues will be sufficient to keep pace with the increased tax component as the sales volumes being generated by existing plant cannot be generated

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proportionately with new capital expenditures due to the continual rise in construction costs. Therefore, the safest way to assure stability of tax expenses in relation to unit revenues is to revert to remaining straight-line depreciation method on existing plant and to utilize straight-line depreciation on new facilities which are installed in the future.

Q. Do you mean to imply that there will be no future growth in plant for Texas Gas? A. No, I am sure that Texas Gas will add to its utility plant, from time to time, in the future. However, the picture, today, concerning future growth potential, is not as rosy as that envisioned by the Commission at the time of its Alabama-Tennessee decision. The present uncertainty with respect to future long-term supplies of natural gas, if not alleviated, could materially alter our growth potential. It would also narrow our competitive advantage with other fuels. These points will be covered, in more detail, by Mr. Elmer, the Chairman of the Board of Directors of Texas Gas and its chief executive officer.

Q. Do you have any further reasons for reverting to a straight-line method of computing tax depreciation? A. Yes. In March of this year the Ways & Means Committee of the United States House of Representatives invited the Federal Power Commission to appear and present testimony on the subject of liberalized depreciation. The Commission, on March 25, 1969,

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through its then Chairman, Mr. White, unanimously recommended that the privilege of utilizing liberalized depreciation should be withdrawn from companies which are subject to the Commission's jurisdiction.

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Q. Did these statements of Chairman White play an important part in the Company's decision? A. It wasn't a motivating factor. But it was certainly an important consideration in the decision of the Board of Directors to revert to a straight-line method of tax depreciation.

Q. Did the decision of the Board take the form of a resolution? A. Yes. The Board unanimously passed a resolution with respect to this matter on May 14, 1969.

Q. Do you have a certified copy of that resolution? A. Yes.

Q. Would you please read the resolution into the record. A. Yes.

"WHEREAS, due to the many disadvantages to the Corporation of continuing to utilize liberalized depreciation provisions of Section 167 of the Internal Revenue Code in computing depreciation, for tax purposes, in light of the Federal Power Commission's (FPC's) policy of depriving the Corporation of all of the benefits thereof; and

WHEREAS, the officers of the Corporation have been authorized, heretofore, to file for an increase in the Corporation's rates for the transportation and sale of natural gas which are subject to the jurisdiction of the FPC; and

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WHEREAS, it is understood that the aforesaid increased rates are based, in part, upon an assumed reversion to a straight-line method of computing depreciation, for

income tax purposes, under Section 167 of the Internal Revenue Code;

Now, Therefore, Be It

Resolved, that the officers of the Corporation be, and they are, hereby directed, once final FPC approval has been received in the form of increased rates, to take the necessary steps to revert to a straight-line method of computing depreciation for tax purposes on properties of the Corporation which are subject to the jurisdiction of the aforesaid Commission for the period as to which the said increased rates apply."

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Testimony of William J. Powell

Q. Would you please state your name, address, and employer. A. My name is William Joseph Powell. I reside at 6905 Heidelburg Road, Lanham, Maryland. I am employed by the Federal Power Commission in Washington, D. C.

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Q. Briefly, what are your duties as Chief of the Division of Systems? A. As Chief of the Division of Systems I am

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responsible for development and design of the Uniform Systems of Accounts and revisions thereto, accounting report forms, accounting regulations, the preparation of accounting interpretations, and financial studies and research related to the Commission's financial responsibilities. I am also responsible for development of record retention requirements and surveillance of financial reports, accounting aspects of certificate applications, journal entries, pro-

spectus applications, and other accounting and related financial matters.

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Q. Are you familiar with the testimony of Mr. Virgil W. Meythaler and the reasons that he gives as to why Texas Gas Transmission Corporation is requesting permission to discontinue the use of liberalized depreciation and to use a straight-line method of computing depreciation for tax purposes? A. Yes. I have read Mr. Meythaler's testimony.

Q. In your opinion do you believe that the reasons given by Mr. Meythaler justify the discontinuance of liberalized tax depreciation?

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A. No. I do not agree that the reasons are sufficient to justify the reversion from liberalized tax depreciation to straight-line depreciation by Texas Gas Transmission Corporation.

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Although the Commission has held both in the Alabama-Tennessee case, Opinion No. 417, 31 FPC 208, and Midwestern Gas Transmission Company that "flow-through" is a proper method whenever a company is in a growing or stable plant situation, it is my opinion that a company should take advantage of the liberalized tax depreciation method allowed by the Internal Revenue Code of 1954 even though their plant should be in a declining situation. To illustrate this fact, I have prepared Exhibit 21 (WJP-3) which shows that under a declining plant situation, that is, where there are no additions to plant, that there will never be any increases in the overall

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taxes paid when a company uses liberalized tax depreciation.

Q. Will you please explain the considerations underlying your Exhibit 21 (WJP-2). A. Exhibit 21 (WJP-2) illustrates the overall tax reductions related to the use of liberalized tax depreciation and the effect that a declining rate base has on taxes related to the return computed on the net book investment. Column 5 of the Exhibit shows the annual tax effect because of the use of liberalized tax depreciation. In the earlier years there would be tax benefits which would be offset in the later years by increases in taxes. Column 9 illustrates the reduction in taxes occasioned by the diminishing rate base. The diminishing amount of return is due to the declining net book investment which is the basis for determining the amount of the return. As illustrated by Column 9, there is a continuous decline in taxes paid which is accelerated in the earlier years from the use of liberalized

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tax depreciation but is not appreciably affected in later years as the tax base declines. This effect is illustrated in Column 10.

Q. Is it your testimony, then, that the request of Texas Gas Transmission Corporation be denied? A. Yes. The arguments presented by Mr. Meythaler are not new and were considered at the time of Alabama-Tennessee and in the Midwestern case.

It is my opinion that sufficient justification relating to plant growth and increases in taxes has not been introduced in this case that would warrant Texas Gas' proposal to switch to straight-line tax depreciation.

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Prepared Direct Testimony of Melwood W. Van Scoyoc

Q. Please state your name. A. Melwood W. Van Scoyoc
Q. Where do you reside? A. Washington, D. C.
Q. What is your business? A. I am President of the firm of Van Scoyoc & Wiskup, Inc., Public Utility Consultants with offices at 1735 K Street, Northwest, Washington, D. C.

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Q. Do you agree with Mr. Meythaler's testimony at page 189, commencing at line 2, that the "Before Tax" coverage is more important than the

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"After Tax" coverage? A. No, I do not.
Q. Why not? A. Because the real earnings available for the payment of interest to bond and debenture holders can only be such earnings as are available after payment of income taxes. It is true that interest is tax deductible however, income tax is a prior lien on the earnings of the corporation. If the corporation pays no income tax the ratios are, of course, identical. I am not convinced that the indicated margin of protection of bondholders against declines in earnings and impairment in the quality of their security can be better measured by the "Before Tax" income rather than "After Tax" income.

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Rebuttal Testimony of V. W. Meythaler

Q. Are you the same Mr. V. W. Meythaler who has already testified in this proceeding? A. Yes.

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Q. Are you familiar with the testimony of Mr. William J. Powell in this proceeding? A. Yes, I have read Mr. Powell's testimony.

Q. On page 10 of his testimony, Mr. Powell states:

"... it is reasonable to assume that Texas Gas will be in a growth situation in the foreseeable future and as experienced over the last 12 years that growth should approximate 7 percent per year."

He supports this conclusion with a statement, also on page 10, that it is reasonable "since there is no indication in the company's testimony to the contrary ..." Do you agree with these statements? A. No, I do not. His estimate is obviously based upon his testimony on page 9 where he says that the average growth rate of Texas Gas for 1957 through 1969 was 7.2%.

Q. Is it your position that Texas Gas will not be in a growth position in the foreseeable future? A. No. In my prior testimony at page 108 (TR. 191), I stated that I was sure that Texas Gas would add to its utility plant, from time to time, in the future. But, I also added:

"However, the picture today, concerning future growth potential, is not as rosy as that envisioned by the Commission at the time of its Alabama-Tennessee decision. The present uncertainty with respect to future long-term supplies of natural gas, if not alleviated, could materially alter our growth potential. It would also narrow our competitive advantage with other fuels."

In addition, Mr. Elmer, at pages 5 through 8 of his testimony, covered the problem of gas shortage and growth potential.

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I would now have to supplement this by adding another limiting factor; namely, the current tight money market.

But, even before these unfavorable conditions appeared, Texas Gas' growth has not been on a consistent basis. Mr. Powell's Exhibit No. 20 (WJP-1) discloses this. You will note, in column 5 of his exhibit, the irregularity of additions from a low of 1.27% in 1957 to a high of 21.25% in 1959, and that 9 out of the 13 years reflected show a growth of less than the average. Using Mr. Powell's 7.27% growth rate, we would have over a billion dollars of plant by 1980 and over two billion dollars by 1989. It is apparent, therefore, that the projection of such a rate of growth for Texas Gas is totally unrealistic.

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Q. At pages 10 and 11 of his testimony, Mr. Powell states

". . . where there are no additions to plant, that there will never be any increases in the overall taxes paid when a company uses liberalized tax depreciation."

Do you agree with that statement? A. No, I do not.

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Q. Will you please explain the reasons for your disagreement? A. Mr. Powell's Exhibit No. 21 (WJP-2) was prepared, according to his testimony, to support the conclusions which you have just quoted. However, his exhibit has many deficiencies. As he has already indicated, per his letter of November 28, 1969, he should have used 92.308% in computing the figures shown in column 5, rather than the 48%. In addition, the tax reductions reflected in column 9 are on a cumulative basis and not on a yearly basis. However, Mr. Powell, in order to get column 10, adds the cumulative reductions in column 9 to the annual reductions in column 5. Therefore, what column 10 reflects is anybody's guess. I don't know what you get when you add something which is computed on an annual basis to something which is set forth on a cumulative basis.

Q. Are there any other defects? A. Yes. Mr. Powell's exhibit necessarily assumes that the company is capitalized on the basis of 100% equity. This is so in view of the fact that he does not reflect the loss of interest as a tax deduction through the amortization of debt. However, in dealing with natural gas pipelines, it is totally unrealistic to assume a company with 100% equity. It is also unrealistic to use such a capital structure to illustrate the effect of continued use of liberalized depreciation by Texas Gas. As Exhibit No. 6 (Statement F(1)1) shows, Texas Gas' debt comprises approximately

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60% of its total capital structure.

Q. Have you prepared an exhibit which would more accurately reflect the information which Mr. Powell purports to show? A. Yes, I have.

Q. Is Exhibit No. 32 (VM-7) such an exhibit? A. Yes, it is.

Q. Was that exhibit prepared by you or under your direction or supervision? A. It was.

Q. Will you please explain what Exhibit No. 32 (VM-7) purports to show? A. Page 1 of Exhibit No. 32 (VM-7) is a comparison of total Federal income taxes on the bases of straight-line and double-declining balance depreciation, assuming 100% equity financing. Hereafter, I will sometimes refer to this latter method of depreciation as "DDB." Column 1 of page 1 represents net book investment or rate base which is the same as column 7 of Exhibit No. 21 (WJP-2). Column 2 represents return at 8% and column 3 represents Federal income taxes using straight-line depreciation and assuming a 48% tax rate. Column 4 represents the excess of DDB depreciation over straight-line depreciation which is the same as column 4 of Exhibit No. 21 (WJP-2).

Column 5 represents Federal income taxes using DDB depreciation assuming a tax rate of 48%.

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Column 3, which illustrates Federal income taxes using straight-line depreciation, shows a *decrease* in taxes each year after the first full year. On the other hand, column 5 shows an *increase* in taxes each year through year 10, then a decline begins which continues until the end of the period. The taxes will increase using DDB depreciation because such depreciation declines in amount each year until the year of reversion to straight line on remaining life. Page 2 sets forth the same basic information as page 1, except that page 2 assumes a 60% debt financing and a 20-year sinking fund, whereas page 1 was based upon an assumed capitalization of 100% equity per Mr. Powell's exhibit. Columns 1 and 2 are identical with columns 1 and 2 of page 1. Column 3 represents the interest computed on an assumed $60,000 debt with sinking funds of $3,000 annually and an interest rate of 6½% per annum. Column 4 represents Federal income taxes using straight-line depreciation at an assumed tax rate of 48%. Column 5 represents the excess of DDB over straight-line depreciation and is identical with column 4 of page 1. Column 6 represents Federal income taxes using DDB depreciation and an assumed tax rate of 48%.

You will note in column 3 on page 1 and in column 4 on page 2 that taxes under straight-line depreciation continue to decline each year for the life of the property. In contrast, it can be seen in column 5 on page 1 and in column 6 on page 2 that taxes under DDB depreciation increase beginning with the first full

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year. When debt financing and related sinking funds are considered, as reflected on page 2, the taxes will increase over a longer period of time.

Q. What conclusions, if any, have you reached as a result of the data reflected in Exhibit No. 32 (VM-7)? A.

Using the same basic assumptions as Mr. Powell, it is apparent that taxes will increase annually for a period of years well beyond the foreseeable future as a result of the continued use of liberalized depreciation contrary to Mr. Powell's flat statement that they would not.

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Q. At pages 15 and 16 of his testimony, Mr. Raymond says that he disagrees with your testimony at transcript 187 wherein you seem to infer, according to him, that in reverting to a straight-line method of computing tax depreciation, you will have additional funds available for new plant construction. Is this a fair interpretation of your testimony?

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A. No, it is not. The testimony to which Mr. Raymond is referring appears in the following question and answer:

"Q. In your opinion, does the Commission's policy of flowing through the benefits of liberalized depreciation to the customer affect Texas Gas' ability to obtain funds for the expansion of its system to meet the increasing demands of its customers?

"A. Yes. Obviously, if the reduction in cost of service, attributable to the temporary reduction in taxes, is passed on, rate-wise, to the customer, such funds are not available for the construction of new facilities. This is particularly significant in a time, such as the present, where the cost of borrowed money is at an all time high."

It is perfectly apparent that I am not contending that a reversion to straight-line, in and of itself, will provide additional funds for construction. I am there stating my opinion that I believe the Commission's policy, with respect to flow through, is totally inappropriate at a time such as the present where the cost of borrowed money is

at an all time high. I most certainly know that, under a flow-through policy of the benefits of liberalized depreciation, there are no funds available for the construction of new facilities from the difference between actual taxes paid and normalized taxes. Only if liberalized depreciation is taken and normalization accounting and rate policies are followed are there actual funds available to the company. I did not say that funds were available in using reverted straight-line depreciation, in fact additional funds will be needed for taxes.

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Q. Was Exhibit No. 33 (VM-8) prepared by you or under your direction or supervision? A. Yes, it was.

Q. Will you please explain that exhibit? A. The purpose of this exhibit is to show the greater ability of Texas Gas to absorb increasing costs, during these inflationary times, under a straight-line tax depreciation method than under DDB with flow-through.

Under straight-line depreciation, there would be greater stability of rates for the customers and more assurance that the company could earn its fair rate of return without an increase in rates. Column 1 of my exhibit sets forth the reductions in total revenue requirements for the five years 1970 through 1974 resulting from the decline in return and Federal income tax requirements on the basis of reverted straight-line tax depreciation.

As noted in footnote 1, the return requirements were computed by maintaining a constant return on common equity and recovering annual capital costs on all other securities. This in effect resulted in the return declining through the operation of sinking funds on both the existing long-term debt projected at December 31, 1969, and annual sinking funds of $3,925,000 on the proposed $78,500,000 of new debt estimated to cost 9.7%. The annual sinking fund require-

ments for debt and preferred capital approximates the annual depreciation claimed by the company in these proceedings.

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In column 3 I have set forth comparable information on the basis of continuing the use of liberalized depreciation on eligible plant. All other assumptions relative to return were identical with the computations in column 1. As you will note, on the straight-line tax depreciation method shown in column 1, the company has the ability to absorb more than $1 million of increased costs in each of the years from 1970 through 1974 or a total of $5,304,000. On the other hand, in column 3 under liberalized depreciation, the ability to absorb costs ranges from $193,000 to $558,000, or a total of $1,875,000 for the 5 years. In order to appraise the significance of this, I have set forth, in column 2, the amounts that would be required for a 7% compound annual increase in salaries and wages for Texas Gas. A 7% compound annual increase in labor costs is consistent with the pattern of union settlements in the first half of 1969. The ability to absorb costs under the liberalized method would be materially lower but for the fact that during the years 1955 through October, 1966, the company, under normalization, had created a reserve for deferred taxes which is now being used as an offset against the increased taxes associated with the company's use of liberalized depreciation on early vintage plant. Of course, as time goes on under flow-through, the amount of deferred taxes available to offset these increased future taxes will be smaller and smaller since no reserves are provided under such a policy. Therefore, the reduction due to decline in return and Federal income taxes in column 3 would be smaller.

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W. M. Elmer

was called as a witness and, having been first duly sworn, was examined and testified as follows:

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Cross-Examination

By Mr. Goldberg:

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Q. And assume further that you were actually endowed with sufficient funds to be able to propose to construct for 400 million a day. Would you come into the Federal Power Commission with an application to build a project involving 400 million a day although for that heating season your need was only 200 million a day? A. Let me try and answer the question this way, and let's try to get on a more realistic instead of a dreaming basis. And I am not saying that in a critical way. But the money is tight. To finance what we have got to pay off right now for what we have spent is going to create great problems. To borrow what—if we go ahead with an expansion program, to borrow it is going to be real tight. So we are going to have to limit our borrowing because of coverage, because of everything else, to a minimal amount.

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If we can ever get over the valley as they are talking about up on the Hill now that is going to happen after all these inflation problems are whipped and so forth, and get back to normal, the kind of an operation that we were in five or six years ago, when we have the coverage, when we have the borrowing ability, when we have the earning ability, I think we will do everything possible to put some

excess capacity into this pipeline. But we won't definitely do it next year.

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Virgil W. Meythaler

was recalled to the witness stand, and having been previously, duly sworn, was examined and testified further as follows:

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Cross-Examination

By Mr. Morrow:

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Q. You testified at lines sixteen and seventeen that you were not contending that an increase in cost ten years down the road is the reason for increasing your rates at this time. Do I understand you to be saying by that that you are not relying on the computations concerning a $4,800,000 increase in costs in 1979 as a basis for going to straight line depreciation now? A. My answer that I gave that got into this problem was that I would want to revert, or utilize, rather than revert—elect to use straight line depreciation on subsequent additions to avoid this problem. Now, naturally, going back to straight

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line at this time would accomodate this problem and alleviate the situation, prolong the day of reckoning, so to speak.

Q. But you are not suggesting that it would be good policy for Texas Gas to incur a five-million-dollar increase in the cost of service in 1970 just to avoid a $4,800,000 tax

increase in 1979, are you? A. I didn't say that. I have other reasons for wanting to go back, yes.

Q. And so your reasons do not include—well, you say you did not say that. A. That's correct.

Q. So we are in agreement there, is that right? A. That's correct.

Q. All right. Thank you. That shortens your cross-examination a good deal.

In your rebuttal testimony on page fifty-nine, 647 of the record, you are there discussing the consequences of a reversion to straight line and the fact that it will not provide additional funds for construction.

Down about line nineteen you state "Only if liberalized depreciation is taken and normalization accounting and rate policies are followed are there actual funds available to the company. I did not say that funds were available in using reverted straight line depreciation. In fact, additional funds will be needed for taxes."

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Are we agreed, then, that if you revert to straight line depreciation there will be additional funds, more funds required for taxes of Texas Gas than if you stay on your accelerated depreciation program that you have been on? A. Yes, same thing as when we flowed through in the first instance, we reversed it, we reduced.

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Q. Would you turn to page 107 of your direct testimony, which is page 190 of the transcript. On that page you seem to be telling us that in order for you to stay even, if you retain the accelerated depreciation program, that you must expand your plant by approximately $41 million next year. Do I read you correctly? A. If the $41 million worth of plant will provide the same capacity, same revenues per dollar of investment as the net investment plant

does, that is correct, because, as you see, when we set a rate based on a tax computation of a certain relationship between book depreciation and tax depreciation, unless you maintain that same relationship that next new rate will not be sufficient to recover the costs applicable to that particular problem.

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Q. But now we are talking— A. However.

Q. Excuse me. Go ahead. A. You know and I know that we cannot put plant in service today at the cost of existing net plant which was constructed with dollars back to 1929 forward. We know what has happened to cost index. It is about 30 percent depreciated. So that isn't possible.

Now, what I tried to make clear here in my rebuttal is that we have to look at this problem from a businessman's standpoint of how do you control costs, how can you maintain stability of rates.

For example, if I could go out and sign a labor contract tomorrow at 50 percent more than they are getting today and no more increases, I would recommend it. Here is a chance that we are not penalizing the customer, we are merely trying to go back to where we were in 1966. This is one more thing that has agravated this whole situation of deterioration of income dollars, as Mr. Keyserling testified. And we are now at the end of the rope. We are trying to re-establish where we were in 1966 before all this thing came about.

Now, I think when Congress gets through we won't have to worry about this, but—

Q. I recognize we may be participating in an exercise in futility if the law changes. But by returning to 1966, what

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you simply mean is going back to the straight-line method of depreciation? A. No, I would say we ought to be back to normalization and taking liberalized depreciation, and

then we would have a little more chance of stability of rates.

Q. Yes, because then in that case you would be then taking more tax dollars from your customers than you had to pay to the Government, wouldn't you? A. Oh, absolutely. We did not pay the taxes, no. They were deferred taxes, right. And we would have the use of them, correct. And that would give us an ability to maintain more of a semblance of stability of rates than we are faced with today under this practice.

Q. Then when you talk about going back to where you were in 1966, you are not talking about going to straight-line depreciation but to accelerated depreciation normalized; is that what you mean? A. In this particular case I am offering to go back to straight-line—revert to straight-line on the remaining—excuse me, on all existing plant. If I were to change this and go back to normalization, it would be higher than what I filed for because I have got to recoup what I gave you since 1966.

Q. Well, I thought you said you just wanted to go back to 1966?

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A. I want to be in the same position that I was in 1966.

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Q. Are you really telling us that Texas Gas cannot count on growth? A. I am saying we cannot count on steady growth. I don't even know whether there is going to be any growth. I have never made that contention. I know I am going to have to add plant just to maintain gas supply.

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Q. Right. And, therefore, you are going to have to grow, aren't you? A. And file a rate increase, yes.

Q. All right. And you are going to have to grow, aren't you? A. And I am trying to avoid that by what I am attempting to do here.

Q. If you do not grow, then your return requirement diminishes as your depreciation reduces your rate base, doesn't it? A. My return requirements would decline as I pay off my debt, yes.

Q. And retire property from your rate base? A. Well, if we would retire property, you are in trouble.

Q. But if you do, if your rate base—if you don't grow, then your requirements for return decrease, don't they? A. Not necessarily. I mean you are assuming that I never add anything. If I never add any plant, your statement would be correct, yes. But that doesn't follow that I would be making too much money even in your views for the next succeeding years.

Q. What I am trying to establish is to get into the real world with you, and in the real world you know Texas Gas' plant is going to continue to grow, isn't it?

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A. I never said that it wasn't.

Q. All right. A. I said it was not going to grow steady.

Q. And furthermore, you know that since it costs more dollars to put in the same amount of plant each year, that if you grow at anything like the rate that you have experienced in the past, it is going to cost you more dollars than it has in the past just to keep the same rate of physical growth, don't you? A. And it is going to cost the customers even more so.

Q. But it is going to cost Texas Gas more, and that means you are going to get greater and greater investments in plant, isn't that right? A. You are wasting your time, Mr. Morrow.

Q. All right.

Thank you. I appreciate the advice. A. I told you

that we would be adding plant. I expect to add plant. What growth is going to be, that is another thing.

Q. You mean how much? A. How much, if any.

Q. Now, are you telling me that you are predicting that perhaps Texas Gas will not grow, its plant won't grow? A. I am almost confident that there will be years when there will be no growth. If we are not able to come up with the adequate gas supply—

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Q. But I mean over the whole— A. —there would be a good chance that there wouldn't be.

Q. I am not talking about one particular year. I mean over the long haul you expect Texas Gas to continue to grow, don't you? A. I hope so.

Q. And you expect it, don't you? A. To some degree.

Q. All right.

. . . . . .

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Q. Did you base your opinion on the importance of before tax coverage on the fact that interest has a prior claim to dollars of revenue prior to—the claim of interest is prior to the claim of Federal income taxes? A. Yes, sir.

Q. And what is your authority for the proposition that

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interest enjoys a higher priority over revenues than Federal income taxes? A. Well, if I had a million dollars of income before interest deductions and now I have a million dollars of interest, there wouldn't be any taxable income, and therefore there would be no taxes. So how can you say that the taxes have a prior claim against income dollars?

Q. If you had a million dollars of income and a million dollars of interest, the before-tax coverage would be iden-

tical, wouldn't it? A. I wouldn't be in business under that assumption, but made it two million if you wish. If it is two million dollars and the interest is a million, Mr. Morrow—

Q. I am using— A. —I have twice as much protection before taxes as I have after taxes. Now, wouldn't you rather be an investor with two million dollars available to pay your one million dollars interest? I mean wouldn't you look at it that way rather than look at it with just the million?

Q. I appreciate the lecture, but I would like an answer to my question.

Mr. Boland: He is answering your question.

By Mr. Morrow:

Q. What is your authority for the statement that the interest has a prior claim to revenues over Federal income

taxes?

Presiding Examiner: Oh, he has explained what he means, Mr. Morrow.

The Witness: The taxes—

Presiding Examiner: Just a minute. If they don't pay interest—they don't have any taxes if they can't pay their interest, that is all he is saying. As a legal matter we all know that the income tax has a prior lien against the assets of the company over interest due to bondholders. But you certainly got to pay the interest before you pay taxes, don't you?

By Mr. Morrow:

Q. Would you agree with that statement of the Examiner, Mr. Meythaler? A. It has a prior lien on assets? You wouldn't have any prior lien, Mr. Morrow, unless you had some taxable income after interest—

Presiding Examiner: That's right.

The Witness: —at some period of time.

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Presiding Examiner: The witness' only point is if your interest uses up your income you have no tax. Isn't that—

Mr. Boland: That's right.

Presiding Examiner: It is as simple as that, isn't it, Mr. Meythaler?

The Witness: Yes, sir. It is just a matter of what would you look at from an investor standpoint for protection or ability to pay the interest obligation. And the more dollars you have, the better off you are. And you know that you come in ahead of Uncle Sam, because interest is a deduction.

By Mr. Morrow:

Q. All right. Now that is the problem. The Examiner stated the law as I understand it, and that is that as a holder of indentures, you don't come in ahead of Uncle Sam.

Presiding Examiner: Well, but if you don't have net income you don't have taxes. That is all there is to it.

Mr. Morrow: All right. And if you don't have net income

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and you don't have taxes, then there is no difference between the before-tax coverage and the after-tax coverage, is there, Mr. Meythaler?

The Witness: There certainly is a difference between the before tax and after-tax coverage.

By Mr. Morrow:

Q. Even without any income taxes? A. If there are no income taxes, the dollars would be the same, right.

Q. There would be no difference. Right. A. Right.

Q. All right. Now what— A. I never said there wasn't.

Q. Now, what is the purpose of having coverage? Why is the coverage requirement so important to an investor or to a rating agency? A. Well, it is a matter of quality, assurance that you will receive your income due, you will receive repayment of your investment.

Q. All right. A. Now, the greater number of dollars ahead of it the more protection you have.

Q. Right. A. It is very simple.

Q. Coverage is a cushion, isn't it?

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A. Yes. And I don't think it is that difficult, because talk to the rating agencies and ask them which is the more important. Or ask an investor. It isn't that complicated.

Q. As your cushion decreases down to 1.0, where you have just exactly enough taxes to pay your interest, which is—I mean excuse me, just enough income to pay your interest, which is the critical point for your investor, at that point your before-tax coverage and your after-tax coverage are identical, aren't they? A. That is true. But your rating would be such that you wouldn't be selling anything anyway.

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Hearing Exhibit No. 20

Exhibit 20 (WJP-1)

TEXAS GAS TRANSMISSION CORPORATION ANALYSIS OF GROWTH OF GAS UTILITY PLANT IN SERVICE FOR THE YEARS 1957 THROUGH 1969

Year (1)	Gas Plant in Service Beginning of Year (2)[1]	Gas Plant in Service End of Year (3)[1]	Net Additions (Col. 3—Col. 2) (4)	Growth Percentage Based on Net Addition Col. 4 ÷ Col. 2 (5)
1957	$210,273,723	$212,947,314	$ 2,673,591	1.27%
1958	212,947,314	218,436,891	5,489,577	2.58
1959	218,436,891	264,859,343	46,422,452	21.25
1960	264,859,343	281,476,913	16,617,570	6.27
1961	281,476,913	299,877,656	18,400,743	6.54
1962	299,877,656	333,635,543	33,757,887	11.26
1963	333,635,543	347,997,643	14,362,100	4.30
1964	347,997,643	364,384,129	16,386,486	4.71
1965	364,384,129	370,785,666	6,401,537	1.76
1966	370,785,666	400,140,243	29,354,577	7.92
1967	400,140,243	425,383,325	25,243,082	6.31
1968	425,383,325	456,017,721	30,634,396	7.20
	Average Growth Rate 1957-1968			6.78%
1969	456,017,721	515,735,6792	59,717,958	13.10%
	Average Growth Rate 1957-1969			7.27%

[1] Amounts for years 1957 through 1967 from FPC Statistics of Interstate Natural Gas Pipeline Companies; 1968 amounts from Texas Gas' FPC Form No. 2 Annual Report. Estimate for 1969 from Statement C, RP69-41.

[2] Total plant from Statement C, RP69-41, less amounts in Accounts 117 and 105 ($527,630,995—($11,002,674 + 892,642)).

ANALYSIS OF THE EFFECT ON TAXES RESULTING FROM THE USE OF LIBERALIZED TAX DEPRECIATION ON A FLOW THROUGH BASIS COMBINED WITH THE REDUCTION IN TAXES BECAUSE OF A DECLINING NET INVESTMENT IN PLANT[1]

Line No.	Gross Plant (1)	Double Declining Tax Depreciation @ 7.018% (2)	Straight Line Depreciation @ 3.509% (3)	Excess of Double Declining Over Straight Line Depreciation Col. 2—Col. 3 (4)	Annual Tax Effect From Use of Liberalized Depreciation Col. 4 x 92.308% (5)	Accumulated Straight Line Depreciation Beginning of Year Col. 3 (6)	Net Book Investment Beginning of Year Col. 1—Col. 6 (7)	Return Reduction Due to Reduction in Net Book Investment Col. 6 x 8% (8)	Tax Reduction Because of Return Reduction Col. 8 x 92.308% (9)[2]	Total Tax Reduction Col. 9 ± Col. 5 (10)
1	$100,000	$3,509	$1,755	$1,754	$1,619	$....	$100,000	$....	$....	$1,619
2	100,000	6,772	3,509	3,263	3,012	1,755	98,245	140	129	3,141
3	100,000	6,297	3,509	2,788	2,574	5,264	94,736	421	389	2,963
4	100,000	5,855	3,509	2,346	2,166	8,773	91,227	702	648	2,814
5	100,000	5,444	3,509	1,935	1,786	12,282	87,718	983	907	2,693
6	100,000	5,062	3,509	1,553	1,434	15,791	84,209	1,263	1,166	2,600
7	100,000	4,707	3,509	1,198	1,106	19,300	80,700	1,544	1,425	2,531
8	100,000	4,377	3,509	868	801	22,809	77,191	1,825	1,685	2,486
9	100,000	4,070	3,509	561	518	26,318	73,682	2,105	1,943	2,461
10	100,000	3,784	3,509	275	254	29,827	70,173	2,386	2,202	2,456
11	100,000	3,518	3,509	9	8	33,336	66,664	2,667	2,462	2,470
12	100,000	3,271	3,509	(238)	(220)	36,845	63,155	2,948	2,721	2,501
13	100,000	3,041	3,509	(468)	(432)	40,354	59,646	3,228	2,980	2,548
14	100,000	2,828	3,509	(681)	(629)	43,863	56,137	3,509	3,239	2,610
15	100,000	2,630	3,509	(879)	(811)	47,372	52,628	3,790	3,496	2,687
16	100,000	2,488	3,509	(1,021)	(942)	50,881	49,119	4,070	3,757	2,815
17	100,000	2,488	3,509	(1,021)	(942)	54,390	45,610	4,351	4,016	3,074
18	100,000	2,488	3,509	(1,021)	(942)	57,899	42,101	4,632	4,276	3,334
19	100,000	2,488	3,509	(1,021)	(942)	61,408	38,592	4,913	4,535	3,593
20	100,000	2,488	3,509	(1,021)	(942)	64,917	35,083	5,193	4,794	3,852
21	100,000	2,488	3,509	(1,021)	(942)	68,426	31,574	5,474	5,053	4,111
22	100,000	2,488	3,509	(1,021)	(942)	71,935	28,065	5,755	5,312	4,370
23	100,000	2,488	3,509	(1,021)	(942)	75,444	24,556	6,036	5,572	4,630
24	100,000	2,488	3,509	(1,021)	(942)	78,953	21,047	6,317	5,831	4,889
25	100,000	2,488	3,509	(1,021)	(942)	82,462	17,538	6,597	6,090	5,148
26	100,000	2,488	3,509	(1,021)	(942)	85,971	14,029	6,878	6,349	5,407
27	100,000	2,488	3,509	(1,021)	(942)	89,480	10,520	7,158	6,607	5,665
28	100,000	2,488	3,509	(1,021)	(942)	92,989	7,011	7,439	6,867	5,925
29	100,000	2,491	3,502	(1,011)	(933)	96,498	3,502	7,720	7,126	6,193

(1215)

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Hearing Exhibit No. 22

FEDERAL POWER COMMISSION
BUREAU OF NATURAL GAS

PROPOSED CHANGE TO STRAIGHT LINE DEPRECIATION FOR TAX PURPOSES

Docket No. RP69-41

Texas Gas Transmission Corporation
Washington, D. C.

November 1969

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TEXAS GAS TRANSMISSION CORPORATION

PROPOSED CHANGE TO STRAIGHT LINE DEPRECIATION FOR TAX PURPOSES

Docket No. RP69-41

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Hearing Exhibit No. 32

Docket No. RP69-41
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TEXAS GAS TRANSMISSION CORPORATION

Comparison of Total Federal Income Taxes Under Straight-Line or DDB Depreciation Assuming 100% Equity Financing

Year	Net Book Investment Per Col. 7 of Ex. (WJP-2) Rate Base	Hearing @ 8% Col. 1 × 8%	Federal Income Taxes Under Straight-Line Depreciation Col. 2 92.308% [1]	Excess of DDB Over Straight-Line Depreciation Per Col. 4 of Ex. (WJP-2)	Federal Income Under DDB Depreciation Col. 2 — Col. 4 92.308% [1]
	(1)	(2)	(3)	(4)	(5)
1	$100,000	$4,000 [2]	$3,692	$1,754 [2]	$2,073
2	98,245	7,860	7,255	3,263	4,243
3	94,736	7,579	6,996	2,788	4,422
4	91,227	7,298	6,737	2,346	4,571
5	87,718	7,017	6,477	1,935	4,691
6	84,209	6,737	6,218	1,553	4,785
7	80,700	6,456	5,959	1,198	4,854
8	77,191	6,175	5,700	868	4,899
9	73,682	5,895	5,441	561	4,924
10	70,173	5,614	5,182	275	4,928
11	66,664	5,333	4,923	9	4,914
12	63,155	5,052	4,663	(238)	4,883
13	59,646	4,772	4,404	(468)	4,836
14	56,137	4,491	4,146	(681)	4,774
15	52,628	4,210	3,886	(879)	4,698
16	49,119	3,930	3,626	(1,021)	4,569
17	45,610	3,649	3,368	(1,021)	4,310
18	42,101	3,368	3,108	(1,021)	4,051
19	38,592	3,087	2,049	(1,021)	3,792
20	35,083	2,807	2,590	(1,021)	3,533
21	31,574	2,526	2,332	(1,021)	3,274
22	28,065	2,245	2,072	(1,021)	3,015
23	24,556	1,964	1,813	(1,021)	2,755
24	21,047	1,684	1,554	(1,021)	2,497
25	17,538	1,403	1,295	(1,021)	2,237
26	14,029	1,122	1,035	(1,021)	1,978
27	10,520	842	777	(1,021)	1,720
28	7,011	561	518	(1,021)	1,460
29	3,502	280	258	(1,011)	1,192

[1] Assumed Federal income tax rate of 48%.
[2] Based on one-half year.

Docket No. RP69-41
Exhibit No. 32 (VM-7)
Page 2 of 2

TEXAS GAS TRANSMISSION CORPORATION

Comparison of Total Federal Income Taxes Under Straight-Line or DDB Depreciation Assuming 60% Debt Financing, 20 Year Sinking Fund

Net Book Investment Per Col. 7 of Ex. (WJP-2) Rate Base	Return @ 8% Col. 1 × 8%	Interest [1]	Federal Income Taxes Under Straight-Line Depreciation Col. 2 — Col. 3 × 92.308% [1]	Excess of DDB Over Straight-Line Depreciation Per Col. 4 of Ex. (WJP-2)	Federal Income Taxes Under DDB Depreciation Col. 2 — Col. —Col. 5 × 92.309% [2]
(1)	(2)	(3)	(4)	(5)	(6)
$100,000	$4,000 [3]	$1,950 [3]	$1,892	$1,754 [3]	$ 273
98,245	7,860	3,802	3,746	3,263	734
94,736	7,579	3,608	3,666	2,788	1,092
91,227	7,298	3,412	3,587	2,346	1,422
87,718	7,017	3,218	3,507	1,935	1,721
84,209	6,737	3,022	3,429	1,553	1,996
80,700	6,456	2,828	3,349	1,198	2,243
77,191	6,175	2,632	3,270	868	2,469
73,682	5,895	2,438	3,191	561	2,673
70,173	5,614	2,242	3,113	275	2,859
66,664	5,333	2,048	3,032	9	3,024
63,155	5,052	1,852	2,954	(238)	3,174
59,646	4,772	1,658	2,874	(468)	3,306
56,137	4,491	1,462	2,796	(681)	3,425
52,628	4,210	1,268	2,716	(879)	3,527
49,119	3,930	1,072	2,638	(1,021)	3,581
45,610	3,649	878	2,558	(1,021)	3,500
42,101	3,368	682	2,479	(1,021)	3,422
38,592	3,087	488	2,399	(1,021)	3,342
35,083	2,807	292	2,322	(1,021)	3,264
31,574	2,526	49	2,286	(1,021)	3,229
28,065	2,245	—	2,072	(1,021)	3,015
24,556	1,964	—	1,813	(1,021)	2,755
21,047	1,684	—	1,554	(1,021)	2,497
17,538	1,403	—	1,295	(1,021)	2,238
14,029	1,122	—	1,036	(1,021)	1,978
10,520	842	—	777	(1,021)	1,720
7,011	561	—	518	(1,021)	1,460
3,502	280	—	258	(1,011)	1,192

[1] Assumed $60,000 debt with sinking funds of $1,500 in years 1 and 21 and sinking fund payments annually for the years 2 through 20. Interest was computed at 6½%.
[2] Assumed Federal income tax rate of 48%.
[3] Based on one-half year.

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Hearing Exhibit No. 33

Docket No. RP69-41
Exhibit No. 33 (VM-8)

TEXAS TRANSMISSION CORPORATION

Comparison of Annual "Cost of Service" Reductions Due to Decline in Return and Federal Income Tax Requirements on the Basis of (1) Reverted Straight-Line Tax Depreciation and (2) Continued Liberalized Depreciation With Flow-Through and Ability To Absorb Annual Wage Increases

Year	Reductions Due to Decline in Return and Federal Income Tax Requirements on the Basis of Reverted Straight-Line Tax Depreciation [1] Column (1)	Annual Difference in Wage Cost [2] (Column (2)	Reductions Due to Decline in Return and Federal Income Tax Requirements on the Basis of Continuing DDB Tax Depreciation [1] Column (3)
1970	$(1,050,000)	$1,105,000	$ (193,000)
1971	(1,092,000)	1,183,000	(281,000)
1972	(1,102,000)	1,265,000	(385,000)
1973	(1,055,000)	1,354,000	(458,000)
1974	(1,005,000)	1,449,000	(558,000)
Totals	$(5,304,000)	$6,356,000	$(1,875,000)

NOTES: [1] Return requirements were computed by maintaining a constant return on Common Equity and recovering annual capital costs on all other securities. Federal Income Tax computation assumes a 50% corporate tax rate.

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Item A

TEXAS GAS TRANSMISSION CORPORATION
3800 Frederica Street
Owensboro, Kentucky 42301
Phone: 502/683-2431

V. W. Meythaler, Senior Vice President

June 26, 1969

Federal Power Commission
441 G Street, N. W.
Washington, D. C. 20426

Attention: Mr. Gordon M. Grant, Secretary

Gentlemen:

Pursuant to the requirements of Section 4 of the Natural Gas Act and the applicable provisions of Section 154.63 of the Commission's Regulations thereunder, Texas Gas Transmission Corporation (Texas Gas) files herewith ten (10) copies of a rate filing (Volumes I, II and III) and a specified number of copies of certain other material, as described below.

Material Submitted

Volume I of the rate filing contains the following items:

1. (a) A letter of transmittal containing a list of the material enclosed with the rate filing.

   (b) A statement of the nature, the reasons, and the bases for the proposed change.

   (c) A list of names and addresses of: (i) all affected customers purchasing gas under Texas Gas' FPC Gas Tariff, Second Revised Volume No. 1; (ii) all affected companies for whom Texas Gas' transportation service is performed under Texas Gas' FPC Gas Tariff, Original Volume No. 2; and (iii) the

regulatory commissions of the States of Louisiana, Arkansas, Mississippi, Tennessee, Kentucky, Illinois, Indiana and Ohio, these being the states in which Texas Gas' jurisdictional resale customers distribute gas.

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(d) A statement of Texas Gas' chief accounting officer as required by Section 154.63(e)(5) of the Commission's Regulations.

(e) An opinion of independent public accountants as required by Section 154.63(e)(6) of the Commission's Regulations.

(f) Original and revised tariff sheets (herein referred to as "Proposed Tariff Sheets") of Texas Gas' FPC Gas Tariff, Second Revised Volume No. 1, as follows:

Original Sheet Nos. 102-B, 102-C, 102-D, and 102-E;

First Revised Sheet Nos. 6, 10, 12, 16, 18, 22, 24, 28, 32-A, 36-A, 40-A, 44-A, 46, 48, 50, 52, 54, 56, 58, 60, 60-B, 62, 64, 66, 68, 84, 85, and 86;

Ninth Revised Sheet No. 68-I;

Tenth Revised Sheet Nos. 60-A, 68-BB, and 70-A;

Eleventh Revised Sheet Nos. 13, 15, and 68-C;

Twelfth Revised Sheet Nos. 7, 9, 19, 21, 25, 27, and 71;

Fifteenth Revised Sheet Nos. 68-G, 68-H, 68-K, and 68-L;

Eighteenth Revised Sheet Nos. 68-A, 68-B, 68-E, and 68-F;

Nineteenth Revised Sheet Nos. 45, 47, 51, 79-I, and 79-J;

Twentieth Revised Sheet Nos. 5, 11, 23, 29, 33, 41, 49, 53, 55, 59, 61, 63, 67, 69, 70, 73, and 74;

Twenty-First Revised Sheet Nos. 17, 31, 35, 37, 43, 57, and 65; and

Twenty-Second Revised Sheet No. 39.

(g) Original and revised tariff sheets (herein referred to as "Alternate Proposed Tariff Sheets") of Texas Gas' FPC Gas Tariff, Second Revised Volume No. 1, as follows:

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First Revised Sheet Nos. 6, 12, 18, 24, 84, 85, and 86;

Ninth Revised Sheet No. 68-I;

Tenth Revised Sheet Nos. 60-A, 68-BB, and 70-A;

Eleventh Revised Sheet Nos. 13, 15, and 68-C;

Twelfth Revised Sheet Nos. 7, 9, 19, 21, 25, 27, and 71;

Fifteenth Revised Sheet Nos. 68-G, 68-H, 68-K, and 68-L;

Eighteenth Revised Sheet Nos. 68-A, 68-B, 68-E, and 68-F;

Nineteenth Revised Sheet Nos. 45, 47, 51, 79-I, and 79-J;

Twentieth Revised Sheet Nos. 5, 11, 23, 29, 33, 41, 49, 53, 55, 59, 61, 63, 67, 69, 70, 73 and 74;

Twenty-First Revised Sheet Nos. 17, 31, 35, 37, 43, 57, and 65; and

Twenty-Second Revised Sheet No. 39.

(h) Revised tariff sheets of Texas Gas' FPC Gas Tariff, Original Volume No. 2, as follows:

Sixth Revised Sheet No. 254; and

Third Revised Sheet No. 332.

(i) Statements A through F, inclusive.

Volume II of the rate filing contains Statement G.

Volume III of the rate filing contains Statements H through M and Statement O.

Volume IV of the rate filing contains the working papers and supporting data pursuant to Sections 154.63(e)(1) and 154.63(e)(4) and 154.63(c)(2) of the Commission's Regulations. Seven (7) sets of these working papers are being simultaneously furnished to the Chief, Pipeline Division, Bureau of Natural Gas.

In addition, seven (7) copies of Texas Gas' FPC Form No. 2, for the year ending December 31, 1968, are also being furnished to the Chief, Pipeline Division, Bureau of Natural Gas.

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Material to be Submitted

Statement P, containing testimony supporting the proposed rates and indicating the line of proof which the company will offer for its case in chief, will be furnished, at a subsequent date, in accordance with Section 154.63(b)(3) of the Commission's Regulations.

Proposed Effective Date

It is proposed that the enclosed tariff sheets designated "Proposed Tariff Sheets" be made effective on August 12, 1969. If the Commission does not grant the waiver of the provisions of Section 154.38(d)(3) of its Regulations,

as hereinafter requested, then it is requested that the enclosed tariff sheets designated "Alternate Proposed Tariff Sheets" be made effective on August 12, 1969.

It is to be noted that forty-five (45) days notice has been allowed in accordance with Section 154.63(e)(4) of the Commission's Regulations.

Posting

Copies of this letter of transmittal, as well as Volumes I, II, and III have been mailed to each of the persons and State Commissions set forth in Volume I hereof. In accordance with the provisions of Section 154.16 of the Commission's Regulations, copies of this filing are available, during regular business hours, for public inspection in a convenient form and place at Texas Gas' main offices in Owensboro, Kentucky.

Purchased Gas Adjustment Clause—Request for Waiver

Certain of the "Proposed Tariff Sheets" include a purchased gas adjustment clause, or incorporate the aforesaid clause by reference thereto. Section 154.38(d)(3) of the Commission's Regulations prohibits the inclusion of such a clause in a rate schedule. It is submitted that the reasons underlying the Commission's adoption of the aforesaid section of the Regulations are no longer applicable. Therefore, Texas Gas hereby requests the Commission

to waive the provisions of that section in the event, and to the extent, that the Commission determines such a waiver to be necessary so that the question of whether such a purchased gas adjustment clause should be permitted to become effective, as a part of Texas Gas' tariff, may be considered in the instant proceeding.

If the Commission does not grant the waiver, as hereinabove requested, then Texas Gas proposes that the enclosed tariff

sheets designated "Alternate Proposed Tariff Sheets" be considered to have been filed in lieu of, and in substitution for, the revised tariff sheets designated as "Proposed Tariff Sheets." The "Alternate Proposed Tariff Sheets" eliminate all references to the purchased gas adjustment clause. In any event, Texas Gas proposes to raise, as an issue in this proceeding, the question of whether a purchased gas adjustment clause should be incorporated into Texas Gas' tariff.

Federal Income Tax Surcharge

Texas Gas has included in its cost of service the currently effective 10 percent Federal income tax surcharge. The presently effective Federal income tax surcharge is scheduled to expire on June 30, 1969. In the event that this surcharge is permitted to expire or is continued in effect at a reduced rate, and such event occurs prior to the date upon which the proposed increase in rates becomes effective, Texas Gas will file substitute tariff sheets reflecting elimination or reduction of the aforesaid surcharge.

Yours very truly,

/s/ V. W. MEYTHALER

Enclosures

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Item B

STATEMENT OF THE NATURE, BASES AND REASONS FOR CHANGES IN TARIFF

Nature of Changes

The tariff sheets filed herewith, when made effective, will increase the charges for service under all of the rate schedules in Texas Gas' FPC Gas Tariff, Second Revised Volume No. 1, and will increase the charges for transportation service to Consolidated Gas Supply Corporation and Gulf Oil Corporation under Rate Schedules Nos. X-21 and X-29, respectively, which are contained in Texas Gas' FPC

Gas Tariff, Original Volume No. 2. The increase in jurisdictional revenues amounts to $36,813,407 per year, based upon the adjusted volumes for the twelve months ended March 31, 1969.[1] Other tariff changes relate to: (1) a modification of the billing demand under Rate Schedules G-1, G-2, G-3 and G-4; (2) a modification of the measurement provisions in the General Terms and Conditions; and, (3) the inclusion of a purchase gas adjustment section in the General Terms and Conditions.

Reasons and Bases of Changes

The increase in rates has been occasioned by increases in costs which are known and are measurable and which are now effective or will become effective within nine months of March 31, 1969, which is the

last month of actual experience reflected in the supporting statements. The increase is mainly attributable to: (1) the increase in rates filed by Texas Eastern Transmission Corporation, a major supplier of Texas Gas, which became effective, subject to refund, on May 15, 1969 in Docket No. RP69-13; (2) increases in cost of gas purchased as a result of purchase of new supplies of gas under new higher priced contracts, as well as increases in the cost of gas under existing contracts; (3) costs related to transportation of gas by others for the delivery of new offshore gas supplies; (4) the proposed discontinuance of the use of liberalized depreciation and the reversion to a straightline method of tax depreciation; (5) costs related to new underground storage facilities; (6) salary and wage increases; and (7) the rate of return required to maintain the financial stability of, and investor confidence in, Texas Gas.

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[1] Based upon the actual volumes of sales and transportation during the twelve months ended March 31, 1969, the increase in jurisdictional revenues amounts to $32,634,612 annually (Statement G, Schedule G-1).

The change in the billing demands under Rate Schedules G-1, G-2, G-3 and G-4 is designed to assure the collection of demand revenues to reimburse the company for at least a portion of the fixed costs associated with additional capacity constructed for the customer's use. Under the currently effective billing demand provisions of the G rate schedules (known as a 90% ratchet), the customer does not pay a demand charge on more than 90% of his contract demand, unless his actual deliveries on any day, during the preceding 12 months, exceed that volume and, then, only to that extent. Therefore, under the existing tariff, unless the actual deliveries to a customer purchasing gas under the G rate schedules exceed 90% of his contract demand on any day, no additional demand revenues are received to help offset the fixed costs associated with the new capacity. It is Texas Gas's position that, in view of

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the potential magnitude of this exposure, and the currently high cost of capital, the ratchet associated with present contract demands should be increased to 95%. With respect to future increases in contract demands, it is proposed that a demand charge will be based on the entire increment but, at th same time, maintaining the flexibility under the old contract demand to the extent of 5%.

The change in the measurement provisions in the General Terms and Conditions provides for the use of the procedures and factors specified in the current *American Gas Association Gas Measurement Committee Report No. 3* in lieu of the superseded *Report No. 2*. *Report No. 3* is the most comprehensive and most accurate method of computing volumes of measured gas currently available. It takes into account more of the factors and variables that affect gas measurement than any other known method. The proposed change in the measurement provisions will not result in an increase in revenues to Texas Gas.

The incorporation of a purchased gas adjustment clause is designed to equitably reflect, in the billing for gas sold to customers by Texas Gas, the actual incurred cost of gas purchased by Texas Gas. These costs are the major item of expense in a pipeline's operation. The inclusion of this purchased gas adjustment clause in the tariff of Texas Gas should substantially reduce frequency of rate increase filings by the company, thus tending to stabilize the basic price structure. The purchased gas adjustment clause does not state the reference base cost of gas, leaving the reference

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amount blank. Texas Gas proposes that, at the time this clause becomes effective, it (Texas Gas) will compute the appropriate base cost of gas and insert such cost in this blank.

Texas Gas has also included, in its proposed purchased gas adjustment clause, refunding procedures relating to refunds received by Texas Gas from its supplier of gas. These procedures are substantially the same as those which have been incorporated, historically, in Texas Gas's rate settlement agreements.

The proposed rates have been designed, basically, on zone costs as more fully explained in Statement K.

There is set forth below a comparison of the presently effective and proposed rates:

	Zone 1		Zone 2		Zone 3		Zone 4	
	Presently Effective	Proposed	Presently Effective	Proposed	Presently Effective	Proposed	Presently Effective	Proposed
SALES								
G, CD, CDL								
Demand	$ 1.25	$ 1.74	$ 1.63	$ 1.95	$ 1.90	$ 2.32	$ 2.58	$ 3.00
Commodity	20.96¢	24.50¢	21.12¢	25.00¢	21.80¢	25.50¢	22.66¢	26.50¢
Variation	4.11¢	5.72¢	5.36¢	6.41¢	6.25¢	7.63¢	8.48¢	9.90¢
SG								
Base-Load	25.89¢	31.50¢	28.89¢	34.50¢	32.39¢	38.00¢	34.39¢	40.00¢
Excess	36.89¢	42.50¢	39.89¢	45.50¢	43.39¢	49.00¢	45.39¢	51.00¢
I, EM, XS	25.07¢	30.22¢	26.48¢	31.41¢	28.05¢	33.13¢	31.14¢	36.45¢
ACQ					28.05¢	33.13¢		
TRANSPORTATION								
X-21								
Demand							$ 1.98	$ 2.20
Commodity							8.50¢	9.80¢
X-29								
Commodity							11.31¢	11.82¢

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[Docketed July 3, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Notice of Proposed Changes in Rates and Charges

(July 3, 1969)

Take notice that Texas Gas Transmission Corporation (Texas Gas) on June 27, 1969, tendered for filing proposed changes in its FPC Gas Tariff, Second Revised Volume No. 1, and Original Volume No. 2, to become effective on August 12, 1969. The proposed rate changes would increase charges for jurisdictional sales and transportation services by $36,813,407 annually, based on volumes for the twelve month period ended March 31, 1969, as adjusted. The proposed increase would be applicable to all of Texas Gas' jurisdictional rate schedules. Texas Gas also proposes a modification of the billing demand ratchet provision under Rate Schedules G-1, G-2, G-3 and G-4 from the existing 90% of contract demand, and a modification of the measurement provisions in the General Terms and Conditions.

Texas Gas states the principal reasons for the proposed rate increases are (1) increases in its cost of purchased gas; (2) costs of transportation by others of new offshore gas supplies and costs related to new underground storage facilities; (3) the proposed reversion from liberalized depreciation to straight line depreciation for tax purposes; (4) salary and wage increases; and (5) the need for an 8.5 percent rate of return.

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[Docketed July 14, 1969]

UNITED STATES OF AMERICA
BEFORE THE FEDERAL POWER COMMISSION

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Motion To Reject Rate Filing

Comes now Memphis Light, Gas and Water Division (Memphis), a customer of Texas Gas Transmission Corporation (Texas Gas) and petitioner for intervention, and moves the Commission to reject the changes filed on June 27, 1969 by Texas Gas in its FPC Gas Tariff, Second Revised Volume No. 1 and Original Volume No. 2, proposed to become effective on August 12, 1969, for the following reasons:

1. The changes filed by Texas Gas include a purchased gas adjustment provision prohibited by Section 154. 38(d)(3) of the Commission's Regulations under the Natural Gas Act.

2. The changes filed by Texas Gas are based upon the use of straight line depreciation instead of liberalized depreciation for tax purposes contrary to judicially-affirmed Commission rule and precedent.

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STATEMENT OF FACTS

On June 27, 1969, Texas Gas filed changes in its FPC Gas Tariff, Second Revised Volume No. 1, and Original Volume No. 2, to become effective August 12, 1969, proposing an annual increase in jurisdictional rates of $36,813,407, based on the 12 months ended March 31, 1969, as adjusted. Of this increase, approximately $5,500,000 annually would be borne by Memphis.

The rate change filing includes alternate sets of revised tariff sheets. One set, designated "Proposed Tariff Sheets", incorporates a purchased gas cost adjustment clause which is set forth in Section 23 of the General Terms and Conditions appearing on proposed Original Sheets No. 102-B through 102-E, inclusive. The other set, designated "Alternate Proposed Tariff Sheets", excludes the purchased gas adjustment clause.

Texas Gas has requested the Commission to waive Section 154.38(d)(3) of its Regulations under the Natural Gas Act, which prohibits inclusion of purchased gas cost adjustment clauses in rate schedules, and to accept for filing the tariff sheets that reflect such clause. Texas Gas proposes that if the Commission does not grant the waiver, the Commission accept for filing the "Alternate Proposed Tariff Sheets".

Texas Gas has also based its increase in rates on a federal income tax allowance calculated on the assumption that straight line depreciation is used by Texas Gas for federal income tax purposes

instead of liberalized depreciation. If Texas Gas had included a federal income tax allowance in its cost of service based on the use of liberalized depreciation, the annual rate increase of $36,813,407 would be substantially less.

ARGUMENT

The Commission has recently held that tariff sheets that include a purchased gas cost adjustment clause should be rejected, and has also denied waiver of its Regulations banning such clauses. *Natural Gas Pipeline Company of America*, Docket No. RP69-36, Order issued June 26, 1969. The Commission there said (mimeo ed., p. 2):

> The reasonableness of including a purchased gas adjustment provision in Natural's tariff has not been

tested in any evidentiary proceeding. If accepted at this time, this provision would become operative after suspension. The purchased gas adjustment provision raises a number of substantive issues which should be fully explored and resolved before the rates and charges to Natural's customers are subjected to changes by application of this proposed adjustment provision. Accordingly, we deem it inappropriate at this time to waive the provisions of Section 154.38(d)(3) of the Commission's Regulations under the Natural Gas Act to permit the filing of Natural's set of revised tariff sheets containing a purchased gas adjustment provision.

The Commission's ruling is decisive in this case, and for the same reasons as expressed in *Natural Gas Pipeline, supra*, the "Proposed Tariff Sheets" tendered by Texas Gas for filing must also be rejected.

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Texas Gas has included in the cost of service submitted in support of its proposed rates a substantial element which as a matter of law and Commission precedent is not allowable. Texas Gas has calculated its federal income tax allowance on the basis of straight line depreciation, instead of making use of the liberalized depreciation method, which would reduce its cost of service by many millions of dollars, and which this Commission has ruled must be used by pipelines for rate-making purposes. *Midwestern Gas Transmission Company, et al.*, Opinions No. 497 and 497-A (July 15 and Sept. 9, 1966, 36 FPC 61 and 36 FPC 599, affirmed 388 F. 2d 444 (CA 7, 1968).

In that case the Commission ruled that rates should be based on costs of services and revenue requirements resulting from the computation of federal income taxes on the basis of liberalized depreciation tax deductions, even though the natural gas company has reverted to the use

of straight line depreciation in its tax returns. The Commission made the general finding that (36 FPC at 85):

> (5) There is no present factual justification for basing the Federal income tax allowances for natural gas companies which maintain either a growing or stable plant on straight-line depreciation tax deductions when liberalized depreciation tax savings are available to such companies, without any genuine detriment or material risk.

The extent to which this unauthorized element of cost affects the rates sought herein by Texas Gas is not apparent from the face

of the filings, but it is clearly substantial.[1]

The filing by Texas Gas, therefore, demonstrates upon its face that the rates which it seeks are not justified and cannot be just and reasonable rates, as required by the Natural Gas Act. Said rates are, therefore, unlawful upon their face and should be rejected.

As was the case in the Natural Gas Pipeline Company proceeding above cited, the reasonableness of including a tax allowance based on straight line depreciation, contrary to the Commission's rule, has not been tested in any evidentiary proceeding but the rates resulting from such allowance would become operative after suspension, if accepted at this time. The issues raised by Texas Gas' clear violation of a Commission ruling "should be fully explored and resolved before the rates and charges to [its] customers are subjected to changes by application of this proposed . . . provision." *Natural Gas Pipeline Company, supra.* Commission prescribed rules may not be vitiated by unilateral action under Section 4(d) of the Act.

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[1] Texas Gas has publicly informed its customers that the item increases costs by $5,000,000. Our analysis indicates that the actual figure may be $7,000,000.

WHEREFORE, for each and all of the reasons set forth above, Memphis' motion should be granted and the rate filing of Texas Gas rejected.

Respectfully submitted,

MEMPHIS LIGHT, GAS AND WATER DIVISION

By REUBEN GOLDBERG
Reuben Goldberg
Its Attorney

REUBEN GOLDBERG
ALLAN FERIDSON
1250 Connecticut Avenue
Washington, D. C. 20036

GEORGE E. MORROW
Union Planters National Bank Building
Memphis, Tennessee 38103

Attorneys for Memphis Light, Gas and Water Division

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VERIFICATION

DISTRICT OF COLUMBIA: ss

Reuben Goldberg, being duly sworn, deposes and says that he is the attorney for Memphis Light, Gas and Water Division and that he is authorized, on behalf of said Division, to execute and file the foregoing Motion to Reject Rate Filing; that he has read said motion and is familiar with the contents thereof, and that the matters and things set forth are true and correct to the best of his knowledge, information, and belief.

/s/ REUBEN GOLDBERG
Reuben Goldberg

Subscribed and sworn to before me this 14th day of July, 1969.

LAWRENCE A. SINCLITICO
Notary Public

My Commission Expires May 14, 1972.

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1880

[Docketed Aug. 11, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Pipeline Rates—Suspension of Proposed Increased Rates —Motion to Reject Rate Filing Denied

Before Commissioners: John N. Nassikas, Chairman; L. J. O'Connor, Jr., John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Order Providing for Hearing, Suspending Proposed Alternate Revised Tariff Sheets, and Denying Motion To Reject Rate Filing

(Issued August 11, 1969)

On June 27, 1969, Texas Gas Transmission Corporation (Texas Gas) tendered for filing proposed changes in its FPC Gas Tariff, Second Revised Volume No. 1 and Original Volume No. 2, to become effective on August 12, 1969.[1] The proposed rate changes would increase charges for jurisdictional sales and transportation services by $36,-

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813,407 annually, based on sales for the twelve month period ended March 31, 1969, as adjusted. Rates would be in-

[1] The tariff sheets (described by Texas Gas as "alternate proposed tariff sheets") hereinafter suspended are as follows: First Revised Sheet Nos. 6, 12, 18, 24, 84, 85, and 86; Ninth Revised Sheet No. 68-I; Tenth Revised Sheet Nos. 60-A, 68-BB, and 70-A; Eleventh Revised Sheet Nos. 13, 15, and 68-C; Twelfth Revised Sheet Nos. 7, 9, 19, 21, 25, 27, and 71; Fifteenth Revised Sheet Nos. 68-G, 68-H, 68-K, and 68-I; Eighteenth Revised Sheet Nos. 68-A, 68-B, 68-E, and 68-F; Nineteenth Revised Sheet Nos. 45, 47, 51, 79-I, and 79-J; Twentieth Revised Sheet Nos. 5, 11, 23, 29, 33, 41, 49, 53, 55, 59, 61, 63, 67, 69, 70, 73 and 74; Twenty-First Revised Sheet Nos. 17, 31, 35, 37, 43, 57, and 65; and Twenty-Second Revised Sheet No. 39 of Second Revised Volume No. 1; and Sixth Revised Sheet No. 254 and Third Revised Sheet No. 332 of Original Volume No. 2.

creased under all sales rate schedules and under transportation rate schedules X-21 and X-29. The filing also proposes a modification of the billing demand ratchet provision under Rate Schedules G-1, G-2, G-3 and G-4 from the existing 90 percent of contract demand to 95 percent of contract demand, and a modification of the measurement provisions in the General Terms and Conditions.

Texas Gas' filing consists of two alternate sets of revised tariff sheets, the first of which contains a proposed new section, to be included in the General Terms and Conditions of the tariff, providing for monthly billing adjustments to reflect current changes in Texas Gas' unit cost of purchased gas.[2] Texas Gas requests that, if the Commission finds that the proposed purchased gas adjustment provision is prohibited by Section 154.38(d)(3) of the Commission's Regulations Under the Natural Gas Act and does not waive the terms of that Section for purposes of Texas Gas' filing, the Commission accept for filing the alternate set of revised tariff sheets, which does not contain a purchased gas adjustment provision.

Texas Gas states that the principal reasons for the proposed rate increases are: (1) increases in its cost of purchased gas; (2) costs of transportation by others of new offshore gas supplies and costs related to new underground storage facilities; (3) the proposed reversion from liberalized depreciation to straight line depreciation for tax purposes; (4) salary and wage increases; and (5) the need for an 8.5 rate of return.

Memphis Light, Gas and Water Division of the City of Memphis, Tennessee (Memphis), on July 14, 1969, filed a motion to reject Texas Gas' rate filing. As grounds for its motion Memphis contends that the proposed tariff changes (1) include a purchase gas adjustment provision

[2] The tariff sheets setting forth Texas Gas' proposed purchase gas adjustment provision are Original Sheets Nos. 102-B, 102-C, 102-D and 102-E.

which is prohibited by Section 154.38(d)(3) of the Commission's Regulations under the Natural Gas Act and (2) are based upon the use of straight line tax depreciation instead of liberalized depreciation for

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tax purposes which Memphis says is contrary to our Opinion No. 497, 497-A.[3] Texas Gas on July 24, 1969, filed its answer to Memphis' motion.[4]

Memphis' contentions raise substantive issues which should be heard in formal proceedings. Memphis' first contention is disposed of by our rejection herein of Texas Gas' revised tariff sheets containing the purchased gas adjustment provision. The objection to the use of straight line tax depreciation goes to the merits of the filing rather than to the question of compliance with our filing requirements with respect to which failure to comply would prompt our rejection of the filing.[5]

The reasonableness of including a purchased gas adjustment provision in Texas Gas' tariff has not been tested in any evidentiary proceeding. If accepted at this time, this provision would become operative after suspension. The purchased gas adjustment provision raises a number of substantive issues which should be fully explored and resolved before the rates and charges to Texas Gas' customers are subjected to changes by application of this

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[3] *Midwestern Gas Transmission Company*, 36 FPC 61, 36 FPC 599, (1966) affirmed *sub. nom. Midwestern Gas Transmission Company* v. *FPC*, 388 F.2d 444 (CA 7, 1968).

[4] On August 1, 1969, Texas Gas, in order to comply with Section 154.63(e)(1) of the Commission's regulations under the Natural Gas Act, filed additional working papers showing the computation of its claim for Federal income taxes, for the test period, reflecting the flow through of liberalized depreciation in accordance with the order issued November 8, 1966, in Docket No. RP67-10.

[5] *Mississippi River Fuel Corp.* v. *FPC*, 202 F.2d 899, (CA 8, 1953).

proposed adjustment provision. Accordingly, we deem it inappropriate at this time to waive the provisions of Section 154.38(d)(3) of the Commission's Regulations under the Natural Gas Act to permit the filing of Texas Gas' set of revised tariff sheets containing a purchased gas adjustment provision. During the pendency of this proceeding, and prior to the determination of this issue, however, Texas Gas will not be precluded from requesting permission to track supplier rate increases which increase the purchased gas costs filed by Texas Gas in this proceeding.

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Review of the filing indicates that certain issues are raised which require development in evidentiary proceedings. The proposed increased rates and charges have not been shown to be justified and may be unjust, unreasonable, unduly discriminatory, or preferential, or otherwise unlawful.

We contemplate that some of the issues involved in this proceeding may be susceptible of hearing and decision within the five months suspension period or shortly thereafter. In order that the collection and refunding of any possible excess charges may be avoided or limited, we are authorizing the Presiding Examiner to determine which issues, if any, may be tried in an initial phase of the hearing.

Twenty-one of Texas Gas' customers have filed petitions for leave to intervene in this proceeding. Notices of Intervention by municipal and State bodies having jurisdiction over the regulation of rates and charges for the sale of natural gas have been filed by City of Cincinnati, City of Columbus, and City of Toledo, all of Ohio, Public Service Commission of Kentucky, Public Service Commission of the State of New York, and Tennessee Public Service Commission.

The Commission finds:

(1) It is necessary and proper in the public interest and to aid in the enforcement of the provisions of the Natural Gas Act that the Commission enter upon a hearing concerning the lawfulness of the rates and charges contained in Texas Gas' FPC Gas Tariff, as proposed to be amended herein, and that the proposed tariff sheets listed in footnote (1) above be suspended, and the use thereof be deferred as herein provided.

(2) It is necessary and proper in the public interest and to aid in the enforcement of the provisions of the Natural Gas Act that the disposition of this proceeding be expedited in accordance with the procedures set forth below.

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The Commission orders:

(A) Pursuant to the authority of the Natural Gas Act, particularly Sections 4 and 15 thereof, the Commission's Rules of Practice and Procedure, and the Regulations under the Natural Gas Act [18 CFR, Chapter I], a public hearing be held commencing on September 25, 1969, 10:00 a.m. (EDST) in a hearing room of the Federal Power Commission, 441 G Street, N. W., Washington, D. C. 20426, concerning the lawfulness of the rates, charges, classifications, services contained in Texas Gas' FPC Gas Tariff, as proposed to be amended herein.

(B) Pending such hearing and decision thereon, Texas Gas' revised tariff sheets listed in footnote (1) above are hereby suspended and the use thereof is deferred until January 12, 1970 and until such further time as they are made effective in the manner prescribed by the Natural Gas Act.

(C) Texas Gas' revised tariff sheets proposing a purchased gas adjustment provision are hereby rejected for filing. These proposed tariff sheets may be made a part

of the record herein, to be considered along with any modifications thereof or alternative provisions submitted by the parties or the Commission Staff, as a proposed purchased gas adjustment provision to be included in Texas Gas' tariff.

(D) At the hearing on September 25, 1969, Texas Gas' prepared testimony (Statement P), filed and served on July 14, 1969, together with its entire rate filing as submitted and served on June 27, 1969, as supplemented on August 1, 1969, be admitted to the record as Texas Gas' complete case-in-chief as provided by Section 154.63(e)(1) of the Commission's Regulations under the Natural Gas Act, and Order No. 254, 28 FPC 495, subject to appropriate motions, if any, by parties to the proceeding.

(E) Following admission of Texas Gas' complete case-in-chief, the parties shall present their views and the Presiding Examiner, in the exercise of his discretion, shall determine

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which issues, if any, shall be heard in an initial phase hearing; fix dates for service of Staff's and Interveners' evidence on such issues and service of Texas Gas' rebuttal testimony; fix dates for witnesses to appear for adoption of their testimony and to stand cross-examination thereon; and proceed with such hearing as expeditiously as feasible. The Examiner shall thereafter fix dates for service of testimony and cross-examination on all issues not being heard in the first phase hearing.

(F) Presiding Examiner Walter T. Southworth, or any other designated by the Chief Examiner for that purpose [See Delegation of Authority, 18 CFR 3.5(d)], shall preside at the hearing in this proceeding; shall prescribe relevant procedural matters not herein provided, and shall control this proceeding in accordance with the policies ex-

pressed in Section 2.59 of the Commission's Rules of Practice and Procedure.

(G) The Motion to Reject Filing of Memphis Light, Gas and Water Division of the City of Memphis, Tennessee is denied.

By the Commission.

(SEAL) KENNETH F. PLUMB,
Acting Secretary.

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1892

[Docketed Sept. 16, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: John N. Nassikas, Chairman; L. J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Order Permitting Interventions

(Issued September 16, 1969)

Petitions requesting leave to intervene in this proceeding have been timely filed by the following petitioners:

Administrator of General Services
Arkansas-Missouri Power Company
Brooklyn Union Gas Company
The Cincinnati Gas and Electric Company and Lawrenceburg Gas Transmission Corporation
Columbia Gas of Ohio, Inc.
City of Columbus, Ohio
Consolidated Gas Supply Corporation

Covington Gas Department, Covington, Tennessee
City of Hamilton, Ohio
City of Henderson, Kentucky
Indiana Utilities Corporation
Louisville Gas and Electric Company
Memphis Light, Gas and Water Division, City of Memphis, Tennessee
Michigan Wisconsin Pipe Line Company

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1968

[Docketed October 20, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

INTERVENTION

Before Commissioners: John N. Vassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Order Permitting Interventions

(Issued October 20, 1969)

Petitions requesting leave to intervene in this proceeding were filed by Texas Eastern Transmission Corporation, Rochester Gas and Electric Corporation and Jackson Utility Division of the City of Jackson, Tennessee after the date fixed for the filing of petitions to intervene. Each petitioner states that, through an oversight, it neglected to file its petition within the time prescribed.

Although these Petitions were not timely filed good cause exists for permitting such interventions.

The Commission finds:

The participation of the above-named petitioners in this proceeding may be in the public interest.

The Commission orders:

(A) The above-named petitioners are hereby permitted to intervene in this proceeding, subject to the rules and regulations of the Commission: *Provided, however,* that the participation of such interveners shall be limited to matters affecting rights and interests specifically set forth in the respective petitions to intervene, and *Provided, further,* that the admission of such interveners shall not be construed as recognition by the Commission that they, or any of them, might be aggrieved because of

. . . . . .

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[Docketed December 1, 1969]

UNITED STATES OF AMERICA
BEFORE THE FEDERAL POWER COMMISSION

Docket No. RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Petition To Intervene of Memphis Light, Gas and Water Division and Objection to Waiver of Commission Regulation Respecting Purchased Gas Adjustment Clauses

Comes now Memphis Light, Gas and Water Division, City of Memphis, Tennessee (Memphis), and respectfully requests that it be permitted to intervene and become a party to this proceeding, and in support of this petition it respectfully states:

I

The exact name and address of petition is as follows:

Memphis Light, Gas and Water Division
179 Madison Avenue
Memphis, Tennessee 38101

II

The names, titles and post office addresses of the persons to whom correspondence or communications should be addressed in regard to this petition are as follows:

Calvin H. Henze, President
Memphis Light, Gas and Water Division
P. O. Box 388
Memphis, Tennessee 38101

Reuben Goldberg, Esq.
Allan Freidson, Esq.
1250 Connecticut Avenue
Washington, D. C. 20036

George E. Morrow, Esq.
Martin, Tate, Morrow & Marston
Union Planters National Bank Building
Memphis, Tennessee 38103

III

Memphis Light, Gas and Water Division is a division and agency of the City of Memphis, Tennessee, a municipal corporation, and was organized under Chapter 381 of the Private Acts of Tennessee for the year 1939, as amended. Among other things, it operates a local distribution system for the distribution and sale of natural gas throughout the City of Memphis and also in Shelby County, Tennessee. It is a city gate customer of Texas Gas Transmission Corporation (Texas Gas), and the natural gas required in the operation of its distribution system is purchased exclusively from Texas Gas.

IV

On November 7, 1969, Texas Gas tendered for filing in the above-entitled proceeding proposed changes in its

FPC Gas Tariff, Second Revised Volume No. 1, to become effective on December 16, 1969. The proposed rate changes would increase charges for jurisdictional sales by $5,031,437 annually, based on volumes for the 12-month period ended March 31, 1969, as adjusted. The proposed increases would be applicable to all of Texas Gas' sales rate schedules. The proposed increase to Memphis would be approximately $700,000 annually.

V

Texas Gas has included by reference the tariff sheets which the Commission rejected by its order issued August 11, 1969, in Docket No. RP69-41 because such sheets included therein a purchased gas adjustment clause which is proscribed by the provisions of Section 154.38(d)(3) of the Commission's Regulations under the Natural Gas Act. The Commission denied Texas Gas' request for waiver of said provisions. For the same reasons advanced by the Commission in its order issued August 11, 1969, the tariff sheets should again be rejected, and waiver of the provisions of Section 154.38(d)(3) should be denied.

VI

As a customer of Texas Gas, Memphis has a substantial interest in the proposed tariff changes and will be affected by them. Memphis is an interested party within the meaning of Section 15(a) of the Natural Gas Act. Its interest may be adversely affected by the Commission's final order herein. Memphis' interest is not adequately represented by any other party. Its intervention and participation in this proceeding is, therefore, necessary and appropriate.

Wherefore, Memphis prays that it be permitted to intervene in this proceeding and be treated as a party hereto, with the right to have notice of and appear at the taking of testimony, to produce and cross-examine witnesses, and

to be heard by counsel upon brief and oral argument, if oral argument is granted. Memphis also prays that

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the tariff sheets that include a purchased gas adjustment clause, tendered by Texas Gas, should be rejected, and waiver of the provisions of Section 154.38(d)(3) should be denied.

Respectfully submitted,

MEMPHIS LIGHT, GAS AND WATER DIVISION

By REUBEN GOLDBERG
Reuben Goldberg
Its Attorney

VERIFICATION

DISTRICT OF COLUMBIA: ss

Reuben Goldberg, being duly sworn, deposes and says that he is the attorney for Memphis Light, Gas and Water Division, and that he is authorized, on behalf of said Division, to execute and file the foregoing Petition to Intervene; that he has read said petition and is familiar with the contents theerof, and that all statements of fact therein set forth are true and correct, to the best of his knowledge, information and belief.

/s/ REUBEN GOLDBERG
Reuben Goldberg

Subscribed and sworn to before me
this 1st day of December, 1969.

J. F. MORRIS
Notary Public

My commission expires: Feb. 14, 1971.

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[Docketed December 15, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

PIPELINE RATES—Suspension of Proposed Increased Rates—Purchased Gas Adjustment

Before Commissioners: John N. Nassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brook, Jr.

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Order Permitting Tracking of Purchased Gas Increase, Suspending Proposed Revised Tariff Sheets Pending Effectiveness of Supplier Rate Increase, and Consolidating Proceedings

(Issued December 15, 1969)

Texas Gas Transmission Corporation (Texas Gas), on November 7, 1969, tendered for filing in Docket No. RP70-14 proposed changes in its FPC Gas Tariff, Second Revised Volume No. 1,[1] designed solely to track the rate increase filed by its supplier, United Gas Pipe Line Company (United), on October 31, 1969, in Docket No. RP70-13 and to become effective on December 16, 1969, or such other day as the increased rates proposed by United become

[1] The proposed revised tariff sheets are as follows: Tenth Revised Sheet No. 68-I; Eleventh Revised Sheet Nos. 60-A, 68-BB, and 70-A; Twelfth Revised Sheet Nos. 13, 15, and 68-C; Thirteenth Revised Sheet Nos. 7, 9, 19, 21, 25, 27, and 71; Sixteenth Revised Sheet Nos. 68-G, 68-H, 68-K, and 68-L; Nineteenth Revised Sheet Nos. 68-A, 68-B, 68-E, and 68-F; Twentieth Revised Sheet Nos. 45, 47, 51, 79-I, and 79-J; Twenty-First Revised Sheet Nos. 5, 11, 23, 29, 33, 41, 49, 53, 55, 59, 61, 63, 67, 69, 70, 73, and 74; Twenty-Second Revised Sheet Nos. 17, 31, 37, 43, 57, and 65; and Twenty-Third Revised Sheet No. 39.

effective subject to refund, or otherwise.[2] The proposed rate changes would increase charges for

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Texas Gas' jurisdictional sales by $5,031,437 annually, based upon volumes for the twelve month period ended March 31, 1969, as adjusted. Rates would be increased under all sales rate schedules.

Texas Gas requests waiver of Section 154.66(b) and (c) of the Commission's regulations to permit its filing of the proposed increased rates during the suspension period of the increased rates in Docket No. RP69-41,[3] in order that the proposed increased rates may become effective coincidentally with those of United.

Texas Gas states that in view of the fact that its proposed increased rates were filed within twelve months from the date of the filing of Statements A thru M, O and P in Docket No. RP-69-41; the proposed rate increase is filed to compensate only for an increase in the cost of purchased gas; and there has been no material change in its facilities, sales volumes and cost of service, other than cost of purchased gas, since the Docket No. RP69-41 filing, it is only required, under Section 154.63(b)(3) of the Commission's Regulations, to file with the Commission Statements L, M, and N as described in Section 154.63. Texas Gas submitted Statement L, which consists of the balance sheets as of the beginning and end of the twelve months ended September 30, 1969 and Statement M, which consists of an income statement for the twelve months ended September 30, 1969. Texas Gas also submitted schedules

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[2] United, in its filing, had requested that its proposed rates become effective on December 16, 1969. As hereinafter indicated those rates were suspended for five months to May 16, 1970.

[3] Docket No. RP69-41 involves a general rate increase filed by Texas Gas on June 27, 1969, which was suspended to January 12, 1970, by order issued August 11, 1969.

setting forth the data and computations from which the proposed increases in rates were derived.

Texas Gas requests waiver of the filing of Statement N on the grounds that it consists of an entire cost of service presentation which would merely duplicate the data which is submitted in the Docket No. RP69-41 filing. In lieu of Statement N, Texas Gas incorporates by reference all the exhibits, items by reference and the prepared testimony which it submitted to the record on September 25, 1969, in Docket No. RP69-41. The company states that it is willing to supply the data required by Statement N on a reasonably expeditious basis should the Commission or its staff determine that such data are necessary.

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We will accept Texas Gas' filing as being in accord with our intention, as expressed in our order issued August 11, 1969, in Docket No. RP69-41, to permit Texas Gas to track supplier rate increases which increase the purchased gas costs claimed by Texas Gas in that docket. And by reason of the facts set forth by Texas Gas, as mentioned above, it is our view that good cause exists for waiving the requirement of the filing of Statement N.

However, as the increased rates proposed herein are directly and entirely based upon the proposed rate increase of United in Docket No. RP70-13, which was suspended to May 16, 1970, by order issued December , 1969, Texas Gas' proposed rate filing should be suspended to that same date. The proposed rate increases have not been shown to be justified and may be unjust, unreasonable, unduly discriminatory or preferential or otherwise unlawful.

In view of the fact that Texas Gas' filing in Docket No. RP-70-14 proposes to further amend its tariff which is the subject of the proceedings in Docket No. RP69-41, as proposed to be amended by its filing in that docket, and that the cost and related data relied upon in support of both

filings is substantially the same, it is appropriate that Docket No. RP70-14 be consolidated with the proceedings in Docket No. RP69-41 for purposes of hearing and decision.

The Commission finds:

(1) It is necessary and proper in the public interest and to aid in the enforcement of the provisions of the Natural Gas Act that the proposed tariff sheets listed in Footnote 1, above be suspended and the use thereof be deferred as herein provided.

(2) It is necessary and proper in the public interest and to aid in the enforcement of the provisions of the Natural Gas Act that Docket No. RP70-14 be consolidated for hearing and decision with with the proceedings in Docket No. RP69-41.

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The Commission orders:

(A) The provisions of Section 154.66(b) and (c) of the Commission's regulations under the Natural Gas Act are waived in order to permit the filing of the proposed rate increase by Texas Gas.

(B) The requirement for the filing of Statement N, as described in Section 154.63 of the Commission's regulations, is waived.

(C) Pending hearing and decision in Docket No. RP-70-14, as consolidated herein, the proposed revised tariff sheets, listed in Footnote 1 above, are suspended and the use thereof is deferred until May 16, 1970, and until such further time as they are made effective in the manner prescribed by the Natural Gas Act, provided, however, that Texas Gas shall not make the increase proposed herein effective prior to the date that the increased rates proposed by United in Docket No. RP70-13 are made effective.

(D) The proceedings in Docket Nos. RP69-41 and RP70-14 are hereby consolidated for purposes of hearing and decision in the matters and issues involved therein.

By the Commission.

(SEAL)

GORDON M. GRANT,
Secretary.

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[Docketed December 23, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Erratum Notice

(December 23, 1969)

ORDER PERMITTING TRACKING OF PURCHASED GAS INCREASE, SUSPENDING PROPOSED REVISED TARIFF SHEETS PENDING EFFECTIVENESS OF SUPPLIER RATE INCREASE, AND CONSOLIDATING PROCEEDINGS

(Issued December 15, 1969)

Page 3, second paragraph, fourth line should read "order issued December 5, 1969, Texas Gas' proposed rate filing"

GORDON M. GRANT,
Secretary.

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[Docketed December 15, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Report of Motion To Omit Initial Decision

TO THE COMMISSION:

On Friday, December 12, 1969, at the close of the hearing on Phase I of this proceeding, counsel for the Commission's staff moved pursuant to section 1.30(c) of the Commission's Rules of Practice and Procedure that the Presiding Examiner's decision be waived and omitted, and that the Commission forthwith render its final decision in Phase I. The respondent, Texas Gas Transmission Corporation, joined in the motion, as did all intervenors whose counsel were present at the hearing that day; viz., Memphis Light, Gas and Water Division; Western Kentucky Gas Company; Louisville Gas and Electric Company; and Jackson, Tennessee, Utility Division. Counsel stated that the Staff does not desire oral argument; however, respondent and all other parties request oral argument before the Commission.

The motion, concurrences and argument in support of the motion appear at transcript pages 1070-1076, copies of which are transmitted herewith.

This proceeding was initiated by order of the Commission issued August 11, 1969, to determine the lawfulness of proposed changes in respondent's FPC Gas Tariff filed June 27, 1969. The proposed changes were suspended until January 12, 1970. Pursuant to the Commission's order, the Presiding Examiner determined that the proceeding

should be conducted in two phases—Phase I to cover the issues with respect to rate of return and principles applicable to the use of straight line versus accelerated depreciation, and related taxes.

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[Docketed December 23, 1969]

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. RP69-41

TEXAS GAS TRANSMISSION CORPORATION

Notice Granting Motion for Waiver of Intermediate Decision

(December 23, 1969)

On December 12, 1969, Commission Staff Counsel moved pursuant to Section 1.30(c) of the Commission's Rules of Practice and Procedure that the intermediate decision in Phase I of the above-designated matter be omitted. The respondent, Texas Gas Transmission Corporation, joined in the motion, as did all interveners whose counsel were present at the hearing that day. On December 15, 1969, the Examiner referred the motion to the Commission.

Upon consideration, the Commission finds that the due and timely execution of the Commission's functions imperatively and unavoidably requires the omission of the intermediate decision, and the motion therefor is granted.

By direction of the Commission.

/s/ GORDON M. GRANT
Gordon M. Grant,
Secretary.

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(Docketed Jan. 16, 1970)

UNITED STATES OF AMERICA

BEFORE THE

FEDERAL POWER COMMISSION

Docket No. RP69-41 (Phase I)

TEXAS GAS TRANSMISSION CORPORATION

Memorandum Initial Brief for Western Kentucky Gas Company

* * * * * * * * * *

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STATEMENT

On June 27, 1969, pursuant to Section 4(d) of the Natural Gas Act, Texas Gas Transmission Corporation filed certain revised tariff sheets specifying new jurisdictional rates and charges. The effect of the proposed tariff changes, as estimated by Texas Gas, would be to increase that company's revenues from jurisdictional sales by some $37 million per annum. On August 11, 1969, pursuant to Section 4(e) of the Act, the Commission suspended the new tariff sheets until January 12, 1970 and set the matter down for hearing. Following discussion among the parties at the prehearing conference, the presiding examiner ruled that the proceedings be divided into two phases, the first phase to deal with the issues of (1) rate of return and (2) Texas Gas' proposal to revert to straight-line depreciation for

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Federal income tax purposes.[1]

[1] Texas Gas has utilized liberalized depreciation for tax purposes since 1955. It followed the practice of "normalization" from that year until October 1, 1966, when it reduced its rates so as to "flow through" the tax benefits resulting from rapid depreciation. During the 11-year period when it normalized, Texas Gas accrued a reserve for deferred taxes (Account 282) amounting to $13,143,624. See Texas Gas' FPC Form No. 2 Annual Report for 1968, pp. 227, 227(b).

The hearing in Phase I was held from December 9-12, 1969; testimony and exhibits were presented by witnesses for Texas Gas, the Memphis Light Gas & Water Division, and the Commission Staff. On December 23, the Commission issued a notice granting the Staff's unopposed motion to omit the intermediate decision procedure.

POSITION OF WESTERN KENTUCKY

Western Kentucky Gas Company distributes gas at retail in 102 communities in the State of Kentucky. The company's service area is in the process of economic expansion, and this is reflected in Western Kentucky's own growth record. Sales have more than doubled during the ten-year period since 1959. During the same period, service was extended to some 33 new communities and to over 34,000 new customers, with much of the growth reflected in sales to residential users.

Western Kentucky is the third largest purchaser (after Memphis and the Louisville Gas & Electric Company) under Texas Gas' general

service (or "G") rate schedules. It purchases gas in three of the four rate zones established under the Texas Gas tariff (Zones 2, 3 and 4), and the vast majority of its distribution system is wholly dependent upon Texas Gas as a source of supply.[2]

Western Kentucky's petition for leave to intervene in this proceeding was granted by order issued September 16, 1969.

Our positions with respect to the two issues set for hearing in Phase I of these proceedings are as follows:

I.

The Commission should allow Texas Gas a rate of return adequate, but no more than adequate, to assure that com-

[2] A non-integrated portion of Western Kentucky's system is supplied with gas purchased from Tennessee Gas Pipeline Company at a point near Danville, Kentucky.

pany's continued aibility to meet the growing demand for natural gas service generally, and, particularly, the growing demand in the areas served by Western Kentucky. In this connection, we are constrained to note that, as of this date, Texas Gas has yet to commit itself to any expansion program to meet customer demands in the 1970-71 heating season (see Tr. 399) and has stated that it will *not* propose *any* expansion program if, in this proceeding, it is limited to a seven and one-half percent rate of return

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(see Tr. 907). We have carefully considered the evidence bearing upon a proper rate of return for Texas Gas. Western Kentucky is well aware of the adverse effects of inflation and the current high cost of debt capital and is persuaded that Texas Gas is entitled to a higher rate of return than it has been allowed in the past. Accordingly, Western Kentucky suggests that in light of current economic conditions and trends, a rate of return in excess of 8 percent would be reasonable.

II.

A. If the Commission should determine that the "flow-through" procedure now followed by Texas Gas is no longer appropriate, we would urge that Texas Gas be required to continue to utilize liberalized depreciation for tax purposes but be allowed to "normalize" for rate purposes.[8] Normalization, as compared with a reversion to straight-line depreciation, would provide a greater cash flow for Texas Gas by

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diverting funds from the U. S. Treasury to the company. At the same time, it would benefit the consumer by provid-

[8] We have reviewed the recently enacted and highly complicated amendments to Section 167 of the Internal Revenue Code. It would appear that the amendments do not affect the Commission's authority to require Texas Gas to "flow-through" to the consumer the benefits derived from liberalized tax depreciation with respect to "pre-1970 public utility property." Thus, the amendments are not dispositive of the issue in this case.

ing, in effect, cost-free plant in an amount equal to the balance in the Account 282 reserve. We assume that Texas Gas would not object to this normalization procedure; witness Meythaler testified (Tr. 994) that he regarded normalization as preferable to a reversion to straight-line depreciation.[4]

B. As we attempted to illustrate by way of cross-examination (see Tr. 1052-1057), the record is cloudy with respect to the mechanics to be employed by Texas Gas in effecting any change in tax depreciation methods. Thus, if the Commission were to approve the proposed reversion to straight-line depreciation and authorize the higher rates that would result therefrom, it is by no means certain when, if ever, Texas Gas would in fact revert to that depreciation method for tax purposes. One reason for the company's inability to provide any firm

assurance on this matter is its uncertainty regarding the possibility of an appeal of any Commission order in this proceeding. If an appeal is pending at the time Texas Gas is required to file its 1970 tax return (September, 1971), the company will "evaluate the circumstances at that time" (Tr. 1057) in deciding upon the depreciation method to be utilized in filing its return.[5]

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[4] We do not understand the reason for the company's apparent preference for straight-line depreciation unless it lies in the view expressed by their witness that the normalization procedure would be more costly to the ratepayer (Tr. 994). This view is based upon a premise we believe to be unsound; namely, that a switch to normalization on a prospective basis would also require a retroactive assessment for the period 1966-1969, during which time the benefits of liberalized depreciation were flowed through to the customers in the form of lower rates rather than credited to the Account 282 reserve.

[5] We assume that a number of factors other than the status of the appellate litigation, factors such as the health of the economy generally and that of the natural gas industry in particular, as well as the financial position of

If permission to revert to straight-line depreciation is granted—and, as noted above, we do not favor such action—the Commission should condition its order so as to protect Texas Gas' customers in the event the company continues to utilize liberalized depreciation for tax purposes. The obvious technique in this regard would be a requirement that Texas Gas credit its Account 282 reserve by an amount reflecting the difference between the taxes actually paid and

the taxes that would have been paid on the basis of straight-line depreciation.

Respectfully submitted,

WESTERN KENTUCKY GAS COMPANY
By CHARLES A. CASE, JR.
Charles A. Case, Jr.
Attorney for
Western Kentucky Gas Company

WILLIAM G. CRAIG
100 St. Ann Street
Owensboro, Kentucky 42301

CHARLES A. CASE, JR.
JOEL YOHALEM
Wolf & Case
1625 K Street, N.W.
Washington, D. C. 20006

Attorneys for Western Kentucky Gas Company

Dated: January 16, 1970

* * * * * * * * * *

Texas Gas, would all enter into the company's determination of an appropriate depreciation method. The examiner made clear his view that the company's inability to indicate how it would in fact pay its taxes was a matter to be dealt with in the briefs, and that inquiry into this matter was not a proper subject for cross-examination.

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Excerpt from Commission Staff Reply, Received February 6, 1970

X. The Tax Depreciation Issue Should Be Decided on the Basis of the Record in This Proceeding and Not on the Basis of the Newly Enacted Tax Reform Act of 1969

Texas Gas, in its initial brief, contends that the passage of the Tax Reform Act of 1969 has the effect of mooting in part the tax depreciation issue in this proceeding, in that the new tax act permits a regulated utility which is presently utilizing liberalized depreciation, and flowing through the benefits thereof to its customers in the form of reduced rates, to elect to switch to normalization or straight line depreciation on future property. Texas Gas takes the position that the Commission should permit it to switch to straight line depreciation on its existing plant, as it intends, under the 180 day option provision of the Act, to elect to go to normalization on its future plant, the effect of which, it says, will be to eliminate, as far as Texas Gas is concerned, the tax savings upon which the Commission's flow-through policy was originally based.

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It is the staff's position that the issue of whether Texas Gas should be allowed to revert from liberalized depreciation to straight line depreciation should be decided on the basis of the record in this proceeding and not on the basis of the provisions of the Tax Reform Act of 1969 nor on the election which Texas Gas says it intends to make thereunder in the future. The tax Act became law after close of the hearings in Phase I of this proceeding. There is therefore nothing in the record with respect to the provisions of this new law. A review of Section 441 of the Act, dealing with depreciation allowed regulated industries, shows that the provisions contained therein are complicated and complex and require further study and analysis.

Moreover, there have been no regulations or guidelines issued by the Internal Revenue Service with respect to the Act.

Under these circumstances Texas Gas is premature in asking the Commission to decide the tax depreciation issue on the basis of this newly enacted tax legislation. The company's request that the Commission make a finding in this proceeding as to the effect on its rates of an election it says it intends to make in the future to switch to a method of depreciation, other than liberalized, in effect, asks the Commission to make determinations

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involving first, an assumption that Texas Gas has already made the election in question and secondly, speculation as to the proper application of the provisions of the Act. Staff submits that the Commission cannot decide this depreciation issue on such an abstract basis.

The Commission cannot properly decide this issue on the basis of an action which Texas Gas may take in the future. Moreover, the election which Texas Gas says it intends to take would have application only to taxable years beginning after December 31, 1970. The pertinent provision of the Act is as follows:

"(4) SPECIAL RULES AS TO FLOW-THROUGH METHOD.—

"(A) ELECTION AS TO NEW PROPERTY REPRESENTING GROWTH IN CAPACITY.—If the taxpayer makes an election under this subparagraph within 180 days after the date of the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity."

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For the foregoing reasons, staff submits that the tax depreciation issue in this proceeding should be decided on the basis of the record herein and not on the hypothetical basis proposed by Texas Gas involving application of the provisions of the Tax Reform Act of 1969.

On the basis of the record in this proceeding, we demonstrated in our initial brief that Texas Gas failed to show sufficient reasons why it should be permitted to revert from liberalized depreciation to straight line depreciation. Its rates should therefore continue to reflect the tax savings attributable to liberalized depreciation.

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2691

(Docketed May 4, 1970)

BEFORE THE

FEDERAL POWER COMMISSION

Docket No. RP69-41 (Phase I)

In the Matter of

TEXAS GAS TRANSMISSION CORPORATION

Motion for Expedited Decision on Limited Issue

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Comes now Texas Gas Transmission Corporation (Texas Gas) and respectfully moves that the Commission expedite its decision with respect to the limited issue of tax depreciation, as it is presented in Phase I of this proceeding and, in connection therewith, to grant the Motion for Oral Argument heretofore made by Texas Gas insofar as it relates to that issue. In support thereof, Texas Gas states as follows:

I

On June 27, 1969, Texas Gas filed a general increase in rates subject to the jurisdiction of the Commission. The

increased rates were proposed to become effective on August 12, 1969. This rate increase included, as one of its cost components, the increased taxes associated with Texas Gas' proposed discontinuance of the use of liberalized depreciation and the reversion to a straight-line method of computing tax

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depreciation. The proposed increased rates were suspended until January 12, 1970.

The initial hearing was held on September 25, 1969, at which time the Presiding Examiner determined that the proceeding would be divided into two phases and that Phase I would concern itself with (1) rate of return and related taxes; and (2) whether Texas Gas, as a matter of principle, should be permitted to return to a straight-line method of computing tax depreciation. The hearings on the Phase I issues concluded on December 12, 1969. The Commission by notice issued December 23, 1969, omitted the intermediate decision. The briefing schedule has been completed and the Phase I issues are now ripe for Commission decision.

At the conclusion of the Phase I hearing, on December 12, 1969, and in conjunction with Staff Counsel's Motion to Omit the Intermediate Decision, counsel for Texas Gas requested oral argument before the Commission (Tr. 1074). This motion was concurred in by Memphis Light, Gas and Water Division (Memphis) (Tr. 1075-76) and by Western Kentucky Gas Company (Tr. 1075). No party opposed the motion.[1]

The Commission has not, as yet, acted upon Texas Gas' motion for oral argument with respect to Phase I issues in this proceeding.

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[1] While Staff Counsel did not oppose the Motion, he did state, in conjunction with his motion to omit the intermediate decision that he did not wish an opportunity to present oral argument (Tr. 1072).

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II

The Tax Reform Act of 1969 provides that a regulated taxpayer presently on flow-through, such as Texas Gas, has a right to elect, within 180 days after the enactment of the new act, to have the provisions which permit flow-through not apply with respect to post-1969 public utility property.[1] If the utility elects to utilize liberalized depreciation with normalization as to such property, permission of the appropriate regulatory agency must be obtained. However, the regulated taxpayer has an unqualified right to elect to use straight-line depreciation with respect to post-1969 public utility property without seeking permission of the regulatory agency.

As set forth in our Initial Brief (p. 77), Texas Gas proposes to exercise its election under the special 180-day rule and indicated its preference to utilize liberalized depreciation with normalization. Before making this election, however, Texas Gas needs assurance from the Commission that it will be permitted to discontinue the use of liberalized depreciation for rate-making purposes with respect to existing plant. This assurance

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is imperative because without it, the Company, if it exercised its option, would be confronted with a continual loss of tax depreciation deductions (approximately $1,100,000 annually Tr. 190) under the continued use of liberalized depreciation on existing property. The loss of tax depre-

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[1] Post-1969 public utility property is defined as ". . . any public utility property which is not pre-1970 public utility property." Pre-1970 public utility property is defined as ". . . property which was public utility property in the hands of any person at any time before January 1, 1970."

The special election applies only to post-1969 public utility property to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer and does not represent the replacement of existing capacity.

ciation deductions results in higher income taxes in the Company's cost of service which necessitates higher rates to recover such taxes. This is so since, once the option is exercised with respect to future property additions which increase capacity, such property would not be eligible for liberalized depreciation and flowthrough accounting and, therefore, could not provide an offset, to any degree, for the loss of tax depreciation on the existing properties.

III

Under the terms of the Tax Reform Act of 1969, the statutory election referred to above (Par. II) must be exercised on or before June 29, 1970.[1] It is essential, therefore, that the Commission issue its decision with respect to the tax depreciation issue in this proceeding prior to June 29, 1970. Otherwise, Texas Gas may be effectively deprived of the benefits which Congress intended it to have under the 180-day election.

In addition, oral argument is entirely appropriate since this is the first case in which a request has been presented to the Commission for permission to discontinue the use of liberalized depreciation for tax purposes.

WHEREFORE, for all of the foregoing reasons, Texas Gas respectfully requests that the Commission render its decision with respect to the tax depreciation issue in Phase I of this proceeding prior to June 29, 1970 and, in connection

[1] Under the provisions of Section 441 of the Act, the election must be made ". . . within 180 days after the date of enactment . . ." of the Act. The Act was approved December 30, 1969 at 9:30 a.m. and the 180th day thereafter falls on Sunday, June 28, 1970. See: *Union Nat'l Bank* v. *Lamb*, 337 U.S. 38, 69 S. Ct. 911 (1949). See also: 35 Fed. Reg. 84 (1970), p. 6871.

therewith, to schedule oral argument at the earliest practicable date prior thereto.

Respectfully submitted,

CHRISTOPHER T. BOLAND
Christopher T. Boland
Attorney for Texas Gas Transmission Corporation

Of Counsel:

GEORGE J. MEIBURGER, ESQ.
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821 Fifteenth Street, N.W.
Washington, D. C. 20005

ROBERT O. KOCH, ESQ.
Vice President & General Counsel
Texas Gas Transmission Corporation
P. O. Box 1160
Owensboro, Kentucky 42301

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(Docketed May 8, 1970)

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL POWER COMMISSION

Docket No. RP69-41 (Phase I)

In the Matter of:
TEXAS GAS TRANSMISSION CORPORATION

Answer of the City of Hamilton, Ohio to Motion for Expedited Decision on Limited Issue

The City of Hamilton, Ohio (Hamilton), pursuant to § 1.12(c) of the Commission's Rules of Practice and Procedure, herewith answers the Motion of Texas Gas Trans-

mission Corporation (Texas Gas) for Expedited Decision on Limited Issue as follows:

I.

Texas Gas asks the Commission to expedite its decision with respect to the issue of tax depreciation in Phase I of this proceeding and, in connection therewith, to grant its earlier Motion for Oral Argument insofar as it relates to that issue.

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In support of its Motion, Texas Gas states that the Tax Reform Act of 1968 permits a regulated utility to make an election with respect to certain alternative depreciation methods for post-1969 utility property and that such election must be exercised on or before June 29, 1970. Texas Gas further states that such election is affected by the Commission's determination as to whether the Company will or will not be permitted to discontinue the use of liberalized depreciation for ratemaking purposes with respect to existing utility plant.

II.

When Congress enacted Section 441 of the Tax Reform Act of 1969, it expressed its intent that the trend toward change-over to the use of liberalized depreciation and flow-through accounting by public utilities be stopped since it results in a loss of tax revenues. Nevertheless, because of countervailing considerations spelled out in the House Report, Congress explicitly rejected the solution of requiring utilities to revert to straight-line depreciation, saying:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation

other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, *this would result in prompt, substantial, and widespread utility rate increases.*[1]

Having rejected the suggestion that utilities be required to revert to straight-line depreciation, the House Report reached the following conclusion:

> Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation . . .[2]

Texas Gas, as well as a number of other pipeline companies, are urging the Commission to sanction a return to straight-line depreciation despite the explicitly stated intent of Congress to the contrary. The reversion by Texas Gas to straight-line depreciation would result in an immediate increased cost to the consumers of some $4.5 million annually.

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Such a reversion to straight-line depreciation by Texas Gas and other major pipeline companies would, indeed, "result in prompt, substantial, and widespread utility rate increases"[3] which Congress specifically sought to avoid by dictating a "freeze" on the depreciation methods currently employed by regulated utilities.

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[1] 2 U. S. Code Cong & Ad. News (1969), p. 1783. [Emphasis supplied.]

[2] *Ibid.*, p. 1783; see also Senate Report, *Ibid.*, pp. 2204-5 and Conference Report, *Ibid.*, p. 2427.

[3] The Commission already had pending before it, as of March 31, 1970, forty pipeline rate cases involving increases in excess of $370 million, a substantial portion of which relates to the tax depreciation issue.

Accordingly, Hamilton agrees that this issue, as it appears in this case, should be resolved without any further delay and would also concur in the request of Texas Gas that oral argument be heard regarding it. Moreover, Hamilton urges that no decision to change Texas Gas' tax depreciation method or the tax depreciation method of any other regulated natural gas company be made until after such argument has been heard.

Respectfully submitted,

THE CITY OF HAMILTON, OHIO
By: J. DAVID MANN, JR.
J. David Mann, Jr.
Its Attorney

Of Counsel:

MORGAN, LEWIS & BOCKIUS
Washington-Philadelphia-Harrisburg

May 8, 1970

2731

(Docketed May 25, 1970)

LAW OFFICES
GALLAGHER, CONNOR AND BOLAND
THE BOWEN BUILDING
WASHINGTON, D. C. 20005

May 22, 1970

Federal Power Commission
441 G Street, N.W.
Washington, D. C. 20426

Attention: Mr. Gordon M. Grant, Secretary

Re: Texas Gas Transmission Corporation,
Docket Nos. RP69-41, et al.

Gentlemen:

Reference is made to the Motion for Expedited Decision on Limited Issue filed by Texas Gas in Docket No. RP69-41

(Phase I) on May 4, 1970. A question has been raised by a customer-intervenor as to the meaning of the following statements set forth on page 3 thereof:

> "As set forth in our Initial Brief (p. 77), Texas Gas proposes to exercise its election under the special 180-day rule and indicated its preference to utilize liberalized depreciation with normalization. Before making this election, however, Texas Gas needs assurance from the Commission that it will be permitted to discontinue the use of liberalized depreciation for rate-making purposes with respect to existing plant."

This letter is being written in order to make it perfectly clear that Texas Gas proposes to use a normalized method of accounting with respect to pre-1970 public utility property if the Commission permits Texas Gas to use normalization for rate-making purposes. Alternatively, Texas Gas proposes to revert to a straight-line method of computing tax depreciation with respect to pre-1970 public utility property, if the Commission permits the associated taxes to be included in Texas Gas' cost of service. Of the two methods, Texas Gas prefers the normalization method.

Respectfully submitted,

CHRISTOPHER T. BOLAND
Attorney for
Texas Gas Transmission Corporation

CTB:rm

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CITY OF WASHINGTON
DISTRICT OF COLUMBIA } ss.

CHRISTOPHER T. BOLAND, being first duly sworn, deposes and says that he is Attorney for Texas Gas Transmission Corporation; that he has read the foregoing letter; that he is familiar with the contents thereof; and that the statements contained therein are true and correct to the best of his knowledge, information and belief, and that he is authorized to file the same with the Federal Power Commission.

CHRISTOPHER T. BOLAND

SUBSCRIBED AND SWORN TO before me this 22d day of May, 1970.

THERESE M. TANGORA
Notary Public

My Commission expires:
December 31, 1970.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all parties of record in this proceeding in accordance with the requirements of Section 1.17 of the Rules of Practice and Procedure.

Dated at Washington, D. C., this 25th day of May, 1970.

/s/ CHRISTOPHER T. BOLAND
Christopher T. Boland

Of Counsel for
Texas Gas Transmission Corporation

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(Docketed June 3, 1970)

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

TEXAS GAS TRANSMISSION CORPORATION

Docket Nos. RP69-41, RP70-14

Opinion No. 578

Opinion and Order Granting Permission To Use Liberalized Depreciation With Normalization for Accounting and Rate Purposes

Issued: June 3, 1970

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

TEXAS GAS TRANSMISSION CORPORATION

Docket Nos. RP69-41, RP70-14

OPINION NO. 578

APPEARANCES

Christopher T. Boland, George Meiburger, Robert O. Koch, and *Steve H. Finch* for Texas Gas Transmission Corporation

Kern G. Beasley and *William H. Hendren* for City of Linton, Indiana, and the City of Jasonville, Indiana

William G. Craig, Charles A. Case, Jr., and *Joel Yohalem* for Western Kentucky Gas Company

O. Grant Bruton for Louisville Gas and Electric Company

J. Harry Mulhern, Edward S. Kirby, and *James R. Lacey* for Public Service Electric and Gas Company

William C. Hart, Giles D. H. Snyder, Ralf Mahaffey, and *John F. Sisson* for Ohio Fuel Gas Company and Columbia Gas of Ohio

Reuben Goldberg, Allan Freidson, and *George E. Morrow* for Memphis Light, Gas and Water Division

Richard M. Merriman, Peyton G. Bowman, III, and *J. Richard Tiano* for Arkansas-Missouri Power Company and Mississippi Valley Gas Company

August L. Griesedieck for Arkansas-Missouri Power Company

James L. Bomar, Jr., and *Jack M. Irion* for United Cities Gas Company

Eugene Ward for Tennessee Public Service Commission, State of Tennessee

Norman A. Flaningam, Charles R. Brown, Henry P. Sullivan, and *Thomas A. White* for Consolidated Gas Supply Corporation

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Paul L. Muilenburg, Marvin H. Morse, and *John Regan* for Administrator, General Services Administration

J. David Mann, Jr., and *John C. Mason* for The City of Hamilton, Ohio

Morton L. Simons and *Kent H. Brown* for Public Service Commission, State of New York

Paul J. Doppes for City of Cincinnati, Ohio

Richard H. Rhein and *Walter E. Beckjord* for The Cincinnati Gas and Electric Company and Lawrenceburg Gas Transmission Corporation

John H. Groves and *Jon D. Noland* for Indiana Gas Company, Inc., and Ohio River Pipeline Corporation

David W. Lanier and *M. Watkins Ewell, Sr.*, for City of Dyersburg, Tennessee

G. Griffin Boyte for City of Humboldt, Tennessee Board of Public Utility

Don S. Smith for Arkansas Public Service Commission

Richard N. George and *John L. Kennedy* for Rochester Gas and Electric Corporation

George O. Benton for Jackson Utility Division, City of Jackson, Tennessee

Jack D. Head and *Joseph F. Weiler* for Texas Eastern Transmission Corporation

Edwin H. Russell, Barbara M. Suchow, and *David C. Johns* for The Brooklyn Union Gas Company

James D. Nestroff for City of Toledo, Ohio

Gayle Malone for Gibson County Utility District, Trenton, Tennessee

Francis J. McShalley for the Staff of the Federal Power Commission

2741

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

ACCOUNT 282; LIBERALIZED DEPRECIATION; FLOW-THROUGH; ACCUMULATED DEFERRED TAXES; NORMALIZATION

Before Commissioners: John N. Nassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

TEXAS GAS TRANSMISSION CORPORATION

Docket Nos. RP69-41, RP70-14

OPINION NO. 578

OPINION AND ORDER GRANTING PERMISSION TO USE LIBERALIZED DEPRECIATION WITH NORMALIZATION FOR ACCOUNTING AND RATE PURPOSES

(Issued June 3, 1970)

NASSIKAS, Chairman:

1. The rate and accounting issues with respect to the property of Texas Gas Transmission Corporation on which liberalized depreciation is now being taken with flow-through of benefits are now before the Commission while other issues in this proceeding are subject to settlement negotiations. The proceedings commenced with the filing of a rate increase by Texas Gas on June 27, 1969, in Docket No. RP69-41, which was suspended until January 12, 1970; a further rate increase was filed on November 7, 1969, in Docket No. RP70-14 to track a rate increase filed by its supplier, United Gas Pipeline Company, and this was suspended until May 16, 1970.

2. At the hearing the proceeding was divided into two phases by the Presiding Examiner with Phase I comprising

questions of rate of return, associated income taxes, and reversion to straight-line depreciation. On motion of Staff Counsel the Commission omitted the intermediate decision with respect to Phase I issues, and briefs were filed by a number of parties. Lately settlement negotiations have been held among the parties and the Commission Staff with respect to both Phase I and Phase II issues, but the issues relating to liberalized depreciation have been left for determination by the Commission. On May 4, 1970, Texas Gas filed a motion for an expedited decision on the tax depreciation issue alleging that under

the Tax Reform Act of 1969, 83 Stat. 487, it would have to make an election with respect to certain "post-1969" property on or before June 29, 1970, and requesting oral argument. An answer to the motion was filed by the City of Hamilton, Ohio, contesting some of Texas Gas' arguments, agreeing that the case should be resolved without any further delay, and also asking for oral argument.

3. Texas Gas now employs liberalized depreciation under Section 167 of the Internal Revenue Code and flows through the benefits to its customers. It alleges that it did not make an election to utilize liberalized depreciation until the Commission had issued a declaratory order that it would permit companies subject to its jurisdiction to normalize taxes for both accounting and ratemaking purposes. *Amere Gas Utilities Co.*, 15 FPC 760 (1956). Under this normalization technique, Texas Gas computed its tax allowance for ratemaking purposes as though it were using stringht-line depreciation, but used liberalized depreciation for computing the amount of taxes actually paid. The difference between taxes collected through its rates and taxes actually paid was credited to Account 282, Accumulated Deferred Income Taxes—Liberalized Depreciation.

4. In *Alabama-Tennessee Natural Gas Company*, 31 FPC 908, 928 (1964), aff'd 359 F. 2d 318 (5th Cir. 1966), *cert. denied* 385 U.S. 847 (1966), we required that the tax benefits of liberalized depreciation be flowed-through to consumers. Texas Gas, for the reasons discussed below, now proposes to abandon flow-through for accounting and ratemaking purposes. For post-1969 property representing an expansion it proposes to effect this by an election under the Tax Reform Act and has shown a preference to utilize liberalized depreciation with normalization. For pre-1970 property, and presumably any other property not subject to the election, it now states by letter dated May 22, 1970, served on all the parties that:

> "This letter is being written in order to make it perfectly clear that Texas Gas proposes to use a normalized method of accounting with respect to pre-1970 public utility property if the Commission permits Texas Gas to use normalization for rate-making purposes. Alternatively, Texas Gas proposes to revert to a straight-line method of computing tax depreciation with respect

> to pre-1970 public utility property, if the Commission permits the associated taxes to be included in Texas Gas' cost of service. Of the two methods, Texas Gas prefers the normalization method."

5. The Tax Reform Act (Section 441 amending Section 167 of the Internal Revenue Code) divides utility property into pre-1970 property (that which was utility property in the hands of any person at any time before January 1, 1970) and post-1969 property (that which is not pre-1970 property). A taxpayer, like Texas Gas, using the flow-through method of accounting may with respect to post-1969 property elect to change to straight-line depreciation, or with our permission to the normalization method, to

the extent the property increases the productive or operational capacity of the taxpayer and does not represent the replacement of existing capacity. Contrary to some of the arguments expressed in the briefs, it is clear that Congress intended this election to apply for ratemaking purposes as well as tax purposes.

6. The Senate Report[1] states that where the election is made "the agency would not be able to impute the use of accelerated depreciation with flow-through"; and the House Report[2] states "the taxpayer will be permitted to elect straight line depreciation as to such new property and, if the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted to in effect force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes." It is true, as the City of Hamilton points out, that the House Committee rejected the suggestion that utilities be required to revert to straight-line depreciation and stated that it intended to "freeze" the current situation regarding methods of depreciation in order to avoid putting the companies at a competitive disadvantage or inducing widespread rate increases, but this was the general

policy and a specific exception was made for an election with respect to post-1969 property where the companies wished to depart from the flow-through method.

7. Referring to these provisions of the Tax Reform Act in our Order No. 404, Statement of Policy, issued May 15, 1970, we determined that it was in the public interest, as to property as to which the election is made, "that electric and natural gas pipeline companies regulated by

[1] Senate Report No. 91-552 on H.R. 13270, pp. 173-174.

[2] House Report No. 91-413 on H.R. 13270, p. 133.

the Commission be permitted to employ a normalization method in their accounts and annual reports, as well as for ratemaking purposes," but we did not decide the ratemaking or accounting issues with respect to other property such as that constructed or acquired prior to January 1, 1970, on which flow-through is being used. Therefore in this proceeding if Texas Gas elects to abandon flow-through on post-1969 property, it is permitted to employ normalization for accounting and ratemaking purposes, but there still must be determined the question whether it may abandon flow-through and use liberalized depreciation with normalization for property not subject to the election, that is the pre-1970 property and the post-1969 property which does not represent an expansion. Under the Tax Reform Act our authority to determine whether a company may effect such a change is not diminished.[3]

8. In our opinion Texas Gas has shown good reason to abandon flow-through for accounting and ratemaking purposes. In *Alabama-Tennessee*, we based our conclusions on our finding that liberalized depreciation would exceed straight-line depreciation where the company continues to make capital additions. Even where the composite plant of a company remains stable, we found, annual liberalized depreciation would not be lower than straight-line depreciation. Thus we concluded that a regulated utility would never be required to pay higher income taxes because of its election to claim liberalized depreciation unless its gross plant declines in dollar value as a result of lower demand or lower plant construction costs. In support of this approach we noted that almost all responsible forecasts reflected the widespread belief that the gas pipeline

industry would continue to expand at least until 1980, and we concluded that the pattern of growth in demand and

[3] See House Report No. 91-413, U.S. Code Congressional and Administrative News, p. A-141.

plant capacity with respect to Alabama-Tennessee and the gas pipeline industry generally would continue for the reasonably foreseeable future. We followed the same approach in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1961), aff'd 388 F. 2d 444 (7th Cir.), *cert. denied*, 392 U.S. 928 (1968). It should be observed that while we were upheld in requiring flow-through in both these cases, the court in neither case indicated that we are required to order that the companies use flow-through.

9. Under the present circumstances the considerations applicable in *Alabama-Tennessee* and *Midwestern* do not obtain. By reason of Texas Gas' proposed election under the Tax Reform Act and Order No. 404, depreciation on its facilities, constructed after the beginning of 1970 which increase its capacity, will be subject to normalization rather than flow-through. Therefore tax depreciation on such new facilities will not be available to offset the declining tax depreciation deductions on the older facilities as contemplated in the *Alabama-Tennessee* and *Midwestern* cases.

10. Excluding new expansion facilities from consideration, the continued use of liberalized depreciation on the pre-1970 plant will not create a tax saving. It is not an answer to urge that the allowable tax depreciation of the pipeline plant remaining after exclusion of the post-1969 expansion facilities will be sufficiently stable to avoid forever repayment of taxes earlier avoided by liberalized depreciation. This is because the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties. In other words, the period of time over which the properties would be useful and depreciable for tax purposes is dependent on the gas supply rather than the useful physical life of the plant. It therefore follows that the pre-1970 tax plant will not be a stable plant in the sense that plant retirements are replaced by new facilities, but the basis of tax depreciation related thereto will decline, so that there is

little chance with respect to this plant that there will be any permanent tax savings. Under these circumstances, therefore, Texas Gas is correct in contending that normalization in computing the tax allowance for rate purposes with respect to its pre-1970 facilities offers more hope for stability of rates for its customers and more assurance that the company can earn its

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fair rate of return without future rate increases. Further benefits of normalization are that it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and that it will help alleviate present day cash shortages.

11. While, of course, Texas Gas is subject to regulation and is required to operate with all reasonable economies,[4] here it would appear that a reversion to normalization with respect to the pre-1970 properties (and post-1969 properties not subject to the election) would lead to more stable tax costs in the long run as far as its customers are concerned. It is likely that tax costs under the flow-through method, while lower at this time than they would be under normalization, could increase in the future, putting financial pressure on the company and creating the need for increased rates. Under these conditions, the company's management is in the best position to examine and pass judgment on these effects, and we are prepared to respect the exercise of managerial discretion at least to the extent of permitting Texas Gas to adopt liberalized depreciation with normalization. Furthermore, upon re-examination of the basis of our *Alabama-Tennessee* and *Midwestern* decisions in the light of the Tax Reform Act of 1969, particularly its effect on post-1969 property, and the impact of the tax law on pipeline property, the findings made in those two cases are no longer applicable, and

[4] See *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (5th Cir. 1960), cert. denied, 366 U.S. 912 (1961).

accordingly the cases are overruled to the extent they are inconsistent with this decision.

12. In reply to the arguments and evidence of Texas Gas on the effect of continuing liberalized depreciation and flow-through, Memphis presents an exhibit which purports to show that even if gross plant leveled off and then declined the use of liberalized depreciation would not require a rate increase, because the decline in return and related income tax would more than counterbalance any increase in tax resulting from lower deductions under liberalized depreciation. With comparable result, the Staff assumes an initial investment with no additions or retirements and shows that in the early years that the property is in service, as tax deductions decline, the advantage to consumers of using liberalized depreciation with flow-through declines until it becomes negative, but this tendency is offset by a tax reduction due to the decline in the rate base. In our opinion, the effect of the declining rate base should not be

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used to offset the effects of liberalized depreciation with flow-through. Where there is no new investment the rate base declines in any case, regardless of the method of tax depreciation. While Texas Gas' pre-1970 properties may represent a declining net investment, the company will undoubtedly be adding to its entire rate base by post-1969 construction, and its operating expenses may well be increasing. Therefore, if Texas Gas remains on flow-through it appears that it may be benefitting present consumers at the unwarranted expense of future consumers. On the other hand, there appears to be little possibility that if Texas Gas chooses to use normalization on its pre-1970 property it will be providing for decreased rates to consumers in later years at the expense of present consumers.

13. To conclude, we shall grant approval to Texas Gas to exercise its discretion to abandon flow-through with

respect to the pre-1970 property and post-1969 non-expansion property and to adopt liberalized depreciation with normalization with respect to this property. Texas Gas, through its election under the Tax Reform Act, already has permission to use liberalized depreciation with normalization with respect to its post-1969 expansion property. Balances in Account 282 should continue to be deducted from the rate base in computing cost of service for ratemaking purposes.

14. Because the issues have been well covered in the briefs we do not think that oral argument is necessary.

The Commission orders:

(A) In the computation of its Federal Income Tax allowance for ratemaking purposes as well as for accounting purposes, Texas Gas is permitted to use liberalized depreciation with normalization with respect to its property other than that subject to election under Section 167(1)(4)(A) of the Internal Revenue Code as amended by Section 441 of the Tax Reform Act of 1969. Such election applies to property constructed or acquired on or after January 1, 1970, to the extent it increases the productive or operational capacity of the company and does not represent the replacement of existing capacity. Texas Gas may reflect any such change in its rates, as well as any change in costs arising from its proposed election. In computing its cost of service for ratemaking purposes balances in Account 282 should continue to be deducted from the rate base.

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(B) Oral argument is denied.

By the Commission.

(SEAL)

GORDON M. GRANT,
Secretary.

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(Docketed June 12, 1970)

BEFORE THE

FEDERAL POWER COMMISSION

In the Matter of

Texas Gas Transmission Corporation

Docket Nos. RP69-41, RP70-14

Motion of Texas Gas Transmission Corporation for Approval of Settlement

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Comes now Texas Gas Transmission Corporation (Texas Gas) and pursuant to Section 1.18(e) of the Commission's Rules of Practice and Procedure submits herewith the attached Stipulation and Agreement in full settlement and disposition of all issues involved in the presently pending proceedings in the above-entitled dockets except tax depreciation. As to the latter, the Stipulation and Agreement states that no provision thereof shall ". . . prejudice the rights which any party may have with respect to the Commission's Opinion No. 578 and Accompanying Order issued on June 3, 1970 relating to tax depreciation in the instant proceeding."

It is requested that the Commission approve the enclosed Stipulation and Agreement and grant such waivers and special permissions with respect to the requirements of the Commission's regulations to the extent

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necessary to effectuate all of the provisions of the aforesaid Stipulation and Agreement.

It is to be noted that Texas Gas, pursuant to its FPC Gas Tariff, will submit its billings for the month of June 1970 by July 10, 1970. It is, therefore, requested that the

Commission approve the enclosed Stipulation and Agreement not later than July 10, 1970 so that the reduced rates provided for in Appendix B thereof can be applied to the billings for the month of June, 1970.

Copies of this Motion and the attached Stipulation and Agreement have been served upon all of the parties to the proceedings in Docket Nos. RP69-41 and RP70-14; all of Texas Gas' jurisidictional customers; and, all interested State Commissions.

WHEREFORE, Texas Gas Transmission Corporation respectfully requests that the Commission approve the attached Stipulation and Agreement, as submitted herewith, at its earliest convenience.

Respectfully submitted,

/s/ CHRISTOPHER T. BOLAND
Christopher T. Boland
Attorney for
Texas Gas Transmission Corporation

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DISTRICT OF COLUMBIA }
CITY OF WASHINGTON } ss.

CHRISTOPHER T. BOLAND, being first duly sworn, deposes and says that he is Attorney for Texas Gas Transmission Corporation; that as such he is authorized to sign and verify the foregoing Motion on behalf of Texas Gas Transmission Corporation; and that the matters and things set forth therein are true and correct to the best of his information, knowledge and belief.

CHRISTOPHER T. BOLAND

SUBSCRIBED AND SWORN to before me this 12th day of June, 1970.

THERESE M. TANGORA
Notary Public

My Commission expires: 12-1-70.

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

TEXAS GAS TRANSMISSION CORPORATION

Docket Nos. RP69-41, RP70-14

Stipulation and Agreement

Filed: June 12, 1970

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Texas Gas proposes to reserve for Commission decision the tax depreciation issue referred to above. The $227,505,967 includes $4,400,000 which is related to this issue. Article II sets forth the manner in which the rates of Texas Gas shall be reduced should the Company be required to continue to use liberalized depreciation with flow-through.

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ARTICLE II

RESERVED ISSUE—TAX DEPRECIATION

This Stipulation and Agreement disposes of all issues with the exception of the appropriate tax depreciation deduction to be reflected in the computation of Texas Gas' income tax allowance to be included in its cost of service. As heretofore indicated, this issue has been specifically reserved for decision by the Commission.

A. *Rate Reductions*

If, as a result of the Commission's decision and order with respect to the tax depreciation issue, Texas Gas is required to continue to use liberalized

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depreciation with flow-through, the jurisdictional rates of Texas Gas shall be reduced by $4,400,000 on an annual basis. In such event, within ten (10) days after the date upon which the Commission's order becomes final and non-appealable, Texas Gas shall file revised tariff sheets, acceptable to the Commission, which reduce the then effective jurisdictional rates of Texas Gas by the unit reductions set forth in Appendix C hereof.

B. *Refunds.*

In the event that Texas Gas is required to make a rate reduction pursuant to Paragraph A of this Article, then Texas Gas shall, concurrently therewith, refund to its jurisdictional customers the amounts determined by multiplying the applicable unit reductions set forth in Appendix C by the actual billing demands and Mcf deliveries of gas purchased by such customers during the period January 12, 1970 to the date upon which Texas Gas shall first begin to charge the reduced rates derived from the unit reductions set forth in Appendix C hereof.

Refunds made pursuant to this paragraph which are applicable to gas sold and transported during the period January 12, 1970 through May 15, 1970 shall include interest at the rate of 8.5%, annually, as provided in Ordering Paragraph (C) of the Commission's order issued January 29, 1970 in Docket No. RP69-41, subject to the Commission's action on Texas Gas' Petition for Modification of that order filed on May 4, 1970. Refunds made

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pursuant to this paragraph which are applicable to gas sold and transported during the period from May 16, 1970, to the date upon which Texas Gas shall first begin to charge the rates derived from the unit reductions set forth in Appendix C hereof, shall include interest at the rate of

8%, annually, as provided in Ordering Paragraph (C) of the Commission's order issued May 15, 1970 in Docket No. RP70-14.

Article III

Tracking Increases and Decreases

While the rates provided for in this Stipulation and Agreement are in effect, Texas Gas may from time to time until November 1, 1971, increase the rates in its FPC Gas Tariff, Second Revised Volume No. 1, to reflect supplier rate increases and shall decrease its rates to reflect supplier rate reductions in accordance with the provisions of this Article.

The reduced rates provided in Appendix B hereof are based on a weighted average cost of gas at 15.025 psia of 21.51¢ per Mcf. If any gas supplier increases or decreases its rates above or below those in effect on May 16, 1970, and a rate increase is permitted or a rate decrease is required hereunder, Texas Gas will file with the Commission, and serve on its customers, a report, acceptable to the Commission, setting forth the computations made in accordance with the following procedure.

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APPENDIX C

TEXAS GAS TRANSMISSION CORPORATION

APPORTIONMENT TO RATE ZONES OF THE COST OF SERVICE EFFECT OF TAX DEPRECIATION

	Revenue Increase	Percent of Total	Cost of Service Effect of Tax Depreciation
Zone 1	$ 5,000,000	19.87%	$ 874,280
Zone 2	587,000	2.33	102,520
Zone 3	4,810,000	19.12	841,280
Zone 4	14,615,000	58.10	2,556,400
Transportation	145,000	0.58	25,520
Total	$25,157,000	100.00%	$4,400,000

UNIT RATE CHANGES RESULTING FROM THE COST OF SERVICE EFFECT OF TAX DEPRECIATION

	Zone 1	Zone 2	Zone 3	Zone 4
Sales Rates				
CD, CDL and G				
Demand	$0.12	$0.08	$0.08	$0.09
Commodity	0.09¢	0.17¢	0.30¢	0.35¢
Allowable Variation	0.39¢	0.27¢	0.26¢	0.29¢
SG				
Base load	0.67¢	0.67¢	0.67¢	0.67¢
Excess	0.67¢	0.67¢	0.67¢	0.67¢
I, EM and XS	0.48¢	0.44¢	0.56¢	0.64¢
ACQ			0.56¢	
Transportation Rates				
X-21				
Demand				$0.04
Commodity				0.14¢

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(Docketed June 29, 1970)

UNITED STATES OF AMERICA

BEFORE THE FEDERAL POWER COMMISSION

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Application for Rehearing

Comes now the Memphis Light, Gas & Water Division, an intervenor in the above docket, pursuant to § 1.35 of the Commission's Rules of Practice and Procedure and Section 19(a) of the Natural Gas Act, 15 USC § 717r, and, being aggrieved as a customer of Texas Gas Transmission Corporation by Opinion No. 578 and accompanying Order in the above Docket, petitions for rehearing of said Opinion and Order on the following grounds:

1. The Commission erred in permitting Texas Gas Transmission Corporation to use for accounting and ratemaking purposes liberalized depreciation with normalization (1) with respect to its property other than that subject to election under Section 167(1)(4)(A) of the Internal Revenue Code, as amended by Section 441 of the Tax Reform Act of 1969, and (2) with respect to its property subject to such election.

2. The Commission erred in finding that the factual considerations and conditions which led to its decisions in *Alabama-Tennessee Natural Gas Company*, 31 FPC 208, 928 (1964), aff'd 359 F2d 318 (CA 5 1966), cert.

denied 385 US 847 and in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1961), aff'd 388 F2d 444 (CA 7), cert. denied 392 US 928, do not obtain in this case with respect to Texas Gas. There is no evidence to support such findings.

3. The Commission erred in finding that tax depreciation on the "new" facilities of Texas Gas, i.e. those constructed after December 3, 1969, will not be available to offset the declining tax depreciation deductions on its older facilities, there being no evidence to support such a finding.

4. In concluding that the continued use of liberalized depreciation on Texas Gas' pre-1970 plant will not create a tax savings, the Commission erred in excluding the effect of liberalized depreciation on new expansion facilities in reaching that conclusion. The tax effect relates to the company as a whole, and cannot factually or legally be compartmentalized between different categories of utility plant.

5. Assuming that the tax effect of liberalized depreciation could be compartmentalized so as to relate separately to the pre-1970 and the post-1969 facilities, nevertheless the Commission erred in finding

(a) that the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties—there being no evidence in the record to support such a finding as to pipe lines

in general or Texas Gas in particular;

(b) that the depreciable life of pipe line properties for tax purposes is dependent on the gas supply rather than the useful physical life of the plant, there being no evidence in the record to support such a finding as to pipe lines in general or Texas Gas in particular.

(c) that the pre-1970 "tax plant" of Texas Gas will not be a stable plant in the sense that plant retirements are replaced by new facilities, but that the tax depreciation related thereto will decline; there being no evidence in the record that pre-1970 plant will decline in amount, or that

any decline in plant would not be offset, for tax depreciation purposes, by the higher cost of replacement plant.

6. The Commission erred in basing its conclusion wholly or partly upon the consideration that use of accelerated depreciation with normalization offers more hope for stability of rates than does the use of flow-through, because, even if this were true, it is unreasonable to purchase a "hope" of future increased stability at a cost of $4,400,000.00 per year, or more, of certain, immediate increase in rates.

7. The Commission erred in finding that the use of accelerated depreciation with normalization will enhance the quality of Texas Gas' securities, there being no evidence in the record to support such finding.

8. The Commission erred in finding that normalization with respect to pre-1970 properties and post-1969 properties not subject to the

election provision of the 1969 Tax Reform Act would lead to more stable tax costs in the future, and that tax costs under the flow-through method are likely to increase in the future, there being no evidence to support either such finding. The only evidence concerning increased tax costs was the company witness's contention that a continuation of flow-through of accelerated depreciation benefits could result in a $4,800,000.00 rate increase in 1978, when depreciation ran out on the company's pre-1954 properties. But even the company witness did not contend that avoidance of a problematical $4,800,000.00 increase in 1978 warranted an immediate increase of $4,400,000.00 or more per year in tax costs passed on to Texas Gas' customers.

9. The Commission erred in substituting the judgment of the company's management for its own appraisal of the effects of the tax treatment allowed to the company.

10. The Commission erred in finding that its findings in its *Alabama-Tennessee* and *Midwestern* decisions are no longer applicable. There is no evidence in this record of a change in general conditions, or in conditions relative to Texas Gas, which would render inapplicable the factual bases upon which those two cases were decided.

11. The Commission erred in finding that if Texas Gas remains on flow-through it may be benefiting present customers at the unwarranted.

expense of future customers. There is no evidence in the record to support such a finding. The *Alabama-Tennessee* and *Midwestern* decisions demonstrated that such eventuality could not happen so long as the company's plant continued to expand, or even if it remained stable. There is no evidence, nor even a claim, that Texas Gas' plant will cease to expand, or will begin to decrease, in the foreseeable future.

12. The Commission erred in granting Texas Gas permission to normalize its tax depreciation, when no request had been made by Texas Gas for such treatment (except for an *ex parte* letter of May 22, 1970, submitted long after the record had been closed on the tax depreciation issue), the issue had not been raised during the hearings, no evidence had been submitted on the issue, and no brief or argument had been submitted on the issue by any party, and no party had been informed that the issue was in any way involved in the case. Such action by the Commission constitutes an abuse of discretion and a denial to the parties of due process of law.

13. The Commission erred in allowing Texas Gas to treat actual tax savings to which it is entitled differently from other savings in any other cost of service, and in failing to require Texas Gas to operate with all reasonable economies, including tax savings.

14. The Commission erred in construing the Tax Reform Act of 1969 as requiring that the election as to post-1969 property apply for rate-making purposes as well as tax purposes, so as to force the Commission to allow for rate-making purposes a change from accelerated depreciation with flow-through to some other form of depreciation.

15. The Commission erred in construing the Tax Reform Act of 1969 as permitting or requiring it to allow use of accelerated depreciation with normalization for either pre-1970 facilities or post-1969 properties of Texas Gas.

WHEREFORE, Applicant prays that the Commission grant rehearing of its Opinion No. 578 and accompanying Order, and upon such rehearing the Opinion and Order be vacated, and that Texas Gas be required to continue to use accelerated depreciation with flow-through, and that its rates be fixed accordingly.

Respectfully submitted,

MEMPHIS LIGHT, GAS AND
WATER DIVISION

By GEORGE E. MORROW
George E. Morrow
Its Attorney

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Attorneys for
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(Docketed June 30, 1970)

BEFORE THE
FEDERAL POWER COMMISSION

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORP.

Answer of New York Commission to Motion for Approval of Settlement

Pursuant to the Commission's notice of June 15, 1970, the Public Service Commission of the State of New York opposes the motion for approval of settlement offer filed herein by Texas Gas Transmission Corporation on June 12, 1970.

In these dockets, Texas Gas is seeking an annual increase in its jurisdictional rates of some $32.0 million. This increase is based, *inter alia*, upon a requested rate of return of 8.5%, and upon a claim for the higher federal income taxes that would result if Texas Gas were permitted to utilize straight-line depreciation in lieu of the accelerated depreciation it has previously used.

Upon motion of staff counsel, concurred in by all parties, the Commission, in December 1969, waived the examiner's decision on the return and tax-depreciation issues. Thereafter, on June 3, 1970, the Commission issued an opinion on the tax-depreciation issue only (Opinion No. 578). In that opinion, the Commission permitted Texas Gas to continue to utilize liberalized depreciation for tax purposes but authorized the company to include in its cost of service the fictitious higher income taxes it would pay if it used straight-line depreciation. Whether this difference—

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stipulated in the pending offer of settlement to be $4.4 million per year—is termed a fictitious expense or merely a

deferred expense, there is no doubt that it is not a current item of expense, and that it bears many of the attributes of return. Indeed, the Commission advanced, as a reason for allowing this fictitious or deferred item, its return-like qualities (Op. 578, mimeo. p. 6):

> "it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and . . . it will help alleviate present day cash shortages."

Based on Texas Gas' current test-year data, the effect of the $4.4 million "normalization" allowance on interest coverage and cash balance is the same as an additional 0.6% return.

The settlement offer whose approval Texas Gas now seeks—and it may be noted that the offer would grant Texas Gas $25.2 million of the $32.0 million it had requested—is apparently predicated on a rate of return allowance of 8%, a full 0.5% higher than the highest rate of return ever allowed by this Commission for any natural gas pipeline, see *Algonquin Gas Transmission Co.*, Op. 571, 43 FPC — (Jan. 19, 1970); and cf. *Florida Gas Transmission Co.*, Op. 561, 42 FPC 74 at 91 (1969). Moreover, neither *Algonquin* nor any prior opinion allowed the inclusion of the return-like "deferred tax" expense, so that, on a return-and-actual-expenses basis, the pending settlement offer is 1.1% in excess of the prior high, rather than merely 0.5%. On Texas Gas' rate base, this 1.1% excess amounts to $8.1 million, or approximately 32% of the $25.2 million increase

that would be allowed if the pending settlement offer were approved.

Under these circumstances, we respectfully suggest that the Commission cannot, consistent with its responsibilities

under the Natural Gas Act, approve the settlement as submitted.

Respectfully submitted,

PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK

By KENT H. BROWN, Counsel
Kent H. Brown, Counsel
44 Holland Avenue
Albany, New York 12208

MORTON L. SIMONS
1819 H Street, N.W.
Washington, D. C. 20006
June 30, 1970

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(Docketed July 2, 1970)

BEFORE THE
FEDERAL POWER COMMISSION

Docket Nos. RP69-41, RP70-14

Texas Gas Transmission Corp.

Application of New York Commission for Rehearing and Reconsideration

Pursuant to the provisions of Section 19(a) of the Natural Gas Act, the Public Service Commission of the State of New York hereby applies for rehearing and reconsideration of Opinion No. 578, issued herein on June 3, 1970. In that opinion, the Commission authorized Texas Gas Transmission Corporation to utilize, for rate purposes, liberalized tax depreciation with "normalization" in lieu of the present flow-through. Wholly aside from the legal errors detailed below, we respectfully suggest that, as a matter of policy, the decision is patently unwise in that it needlessly encourages an industry-wide inflation of pipe-

line rates, and we urge the Commission to reconsider its action in light of these consequences.

Procedural Errors Underlying Opinion No. 578

The Commission committed two major procedural errors in its June 3 opinion. First, it failed to decide the depreciation issue before it, deciding instead a quite different issue, and one that had never been properly presented to it. Under the Texas Gas filing, under the evidence presented, and under the motion to sever Phase I issues, the sole depreciation issue was whether Texas Gas should be granted permission

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to abandon liberalized depreciation with flow-through in order to change to straight-line depreciation for tax purposes. In its opinion, however, the Commission authorized Texas Gas to adopt liberalized depreciation with normalization. With all respect, we submit that this issue was not properly before the Commission and that its consideration by the Commission deprived the parties of due process of law.

Second, what had been severed for decision by the Commission in Phase I of this proceeding were *both* the tax depreciation issue and the rate of return allowance. The interrelationship of these two issues was, in fact, explicitly recognized—although the logical results flowing from that interrelationship were not—by the Commission at page 6 of its opinion, where it noted that the normalization treatment it had permitted

> "will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and . . . it will help alleviate present day cash shortages."

In light of this interrelationship, we do not believe that the Commission was free to decide one of the Phase I is-

sues without also weighing its effect on, and deciding, the other.

The Basic Error of Opinion No. 578

The precise rationale underlying the decision reached by the Commission in Opinion No. 578 does not shine forth with the utmost clarity. It appears, however, that the decision rests on two principal bases: (1) that inasmuch as Texas Gas will use liberalized depreciation with normalization for its post-1969 non-expansion properties, "there is little chance . . . that there will be any permanent tax savings" resulting

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from the use of liberalized depreciation with respect to existing (pre-1970) properties; and (2) that the Commission should "respect the exercise of [the pipeline's] managerial discretion" to utilize liberalized depreciation with normalization. The first reason is not supported by the evidence of record but is in fact contrary to such evidence. The second reason is not a valid reason for Commission action under the Natural Gas Act, as a matter of law. Furthermore, although the Commission correctly states (mimeo. pp. 3-4) that it was "the general policy" of Congress in enacting Section 441 of the Tax Reform Act of 1969 "to 'freeze' the current situation regarding methods of depreciation in order to avoid . . . induring widespread rate increases," it is self-evident that the general policy adopted by the Commission in Opinion No. 578 is the precise opposite of that which the Commission ascribes to the Congress; yet there is not a word in the Commission's opinion which even attempts to reconcile this glaring inconsistency.

It is, of course, absolutely clear that there is nothing in the language of Section 441 which directs the Federal Power Commission or any other regulatory agency to adopt or endorse any particular rate treatment with re-

spect to either new or existing property. But even if there were some ambiguity in the statute on this point—and obscurity is by no means the same as ambiguity—reference to the legislative history would preclude the result reached by the Commission in Opinion No. 578. While the particular provision under discussion was merely one small

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part of a much larger comprehensive tax reform act and perhaps as a consequence received only limited Congressional attention, the Conference Report on the bill does provide guidance. After noting that the purpose of Section 441 was to prevent a regulated utility from choosing accelerated depreciation for tax purposes "unless it 'normalizes' the current income tax reduction resulting from the use of such accelerated depreciation," the Report then specifically states:

> "This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account."

Yet, the Commission in Opinion No. 578, in direct contravention of the explicit intent expressed in the Conference Report, would apply the rule to pipelines presently flowing through the tax reductions.

It cannot seriously be argued that Section 441 of the Tax Reform Act modifies or was intended to modify the long-established regulatory rule that a utility must operate with all reasonable economies and that only prudent expenditures will be recognized for rate-making purposes. Accordingly, since there is no evidentiary basis in this record for finding that use of liberalized depreciation by Texas Gas will result merely in a tax deferral rather than a tax saving, there is no rational reason for the Commission to permit Texas Gas to inflate its gas rates to reflect a wholly fictitious tax.

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WHEREFORE, the Public Service Commission of the State of New York respectfully requests the Commission to grant rehearing and reconsideration of Opinion No. 578 and, upon such reconsideration, to rescind said opinion and deny Texas Gas Transmission Corporation permission to withhold from its customers the savings accruing from the use of accelerated tax depreciation.

Respectfully submitted,

PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK

By KENT. H. BROWN
Kent H. Brown, Counsel
44 Holland Avenue
Albany, New York 12208

MORTON L. SIMONS
1819 H Street, N.W.
Washington, D. C. 20006

July 1, 1970

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VERIFICATION

District of Columbia) ss:

MORTON L. SIMONS, being duly sworn, deposes and says that he is an attorney for the Public Service Commission of the State of New York, that he has prepared and is authorized to execute and file the foregoing application, and that the facts alleged therein are true and correct to the best of his knowledge, information, and belief.

MORTON L. SIMONS

Sworn to and subscribed before me this 2nd day of July, 1970.

/s/ MAY DRILL METCALFE

My Commission Expires Feb. 15, 1971.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all parties of record in this proceeding in accordance with the requirements of § 1.17 of the Rules of Practice and Procedure.

Dated at Washington, D.C., this 2nd day of July, 1970.

MORTON L. SIMONS
Morton L. Simons

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BEFORE THE
FEDERAL POWER COMMISSION

Docket Nos. RP69-14 and RP70-14

In the Matter of
TEXAS GAS TRANSMISSION CORPORATION

Response of Texas Gas Transmission Corporation to Answer of the New York Commission

Comes now Texas Gas Transmission Corporation (Texas Gas) and files its response to the Answer of the New York Commission filed on June 30, 1970 in the above-entitled proceedings as follows:

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II

The New York Commission contends that, as a result of the Commission's Opinion No. 578 and accompanying order issued on June 3, 1970 in the instant proceedings, Texas Gas will be permitted to continue to utilize liberalized depreciation for tax purposes and to normalize for accounting and rate purposes. This is accurate.

The New York Commission further contends, however, that the $4,400,000 which has been stipulated as the amount

involved in the tax depreciation issue represents an allowance of ". . . an additional 0.6% return."[1] We categorically deny that normalization will provide Texas Gas with 0.6% of additional return or, in fact, any return whatever.[2]

Under normalization accounting, the difference in taxes on income which are payable because of the use of liberalized depreciation in computing such taxes, as compared to the taxes payable using the depreciation deduction otherwise appropriate and allowable for tax purposes, is

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credited to Account No. 282 of the Uniform System of Accounts entitled "Accumulated Deferred Income Taxes —Liberalized Depreciation" and the same amount is debited to Account No. 410 entitled "Provision for Deferred Income Taxes." Account No. 282 is a reserve for deferred taxes. The utility is restricted in its use of this account. For example, it cannot transfer the balance in the account, or any portion thereof, to surplus or make any use thereof except as specifically provided in the text of the account without prior approval of the Commission. Obviously, this reserve cannot be used for the payment of dividends or distributed, in any form, to the stockholders. Unlike return, it is not available to the investors. It is a reserve for deferred taxes and specifically restricted for such purposes.

The contra entry, as stated above, is a debit to Account No. 410 which, in accordance with accounting practices pre-

[1] In this connection, it is to be noted that the New York Commission and Memphis Light, Gas and Water Division have filed Applications for Rehearing of the Commission's Opinion No. 578 and accompanying order issued on June 1, 1970 in the instant proceeding, alleging that the Commission has improperly and erroneously permitted Texas Gas to use liberalized depreciation with normalization for accounting and rate-making purposes.

[2] The derivation of the 0.6% has not been shown or explained.

scribed both by the Commission and the Accounting Principles Board, is treated as any other expense. Thus, it is deducted from income to determine Net Operating Revenues (return) and Net Income so that the deferred tax amount is likewise not available for interest or dividend payments or for distribution to stockholders.

In addition, the Commission, in its Opinion No. 578, *supra,* has provided, in Ordering Paragraph (A) thereof, that:

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> "In computing its cost of service for rate making purposes balances in Account 282 should continue to be deducted from the rate base."

Therefore, the Commission has made it perfectly clear that it does not intend to permit Texas Gas to earn any return on such balances. If the deferred taxes or the reserve really represented return to the stockholders, the Commission could not constitutionally enforce any of these restrictions. Thus, it cannot be argued, seriously, that the deferred tax account represents funds which have any of the "essential" or "fundamental" ingredients of return.

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(Docketed July 6, 1970)

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL POWER COMMISSION

Docket Nos. RP69-41 and RP70-14

In The Matter of:
Texas Gas Transmission Corporation

Petition of Philadelphia Gas Works Division of UGI Corporation for Rehearing

To THE FEDERAL POWER COMMISSION:

COMES NOW, the Philadelphia Gas Works Division of UGI Corporation, an intervenor in one of the above consolidated dockets, pursuant to Section 1.35 of the Commission's Rules of Practice and Procedure, and Section 19(a) of the Natural Gas Act, 15 USC § 717(r), and Petitions for Rehearing of the Commission's Opinion No. 578 in the above matter and specifies the following errors therein:

1. The Commission erred in relying upon the effect of the Tax Reform Act of 1969 as a basis for overruling the principles of flow-through of liberalized depreciation it established in *Alabama-Tennessee Natural Gas Co.*, 31 F.P.C. 208 (1964), *aff'd.* 359 F.2d 318 (5th Cir. 1966), *cert. denied* 385

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U.S. 847, and *Midwestern Gas Transmission Co.*, 36 F.P.C. 61 (1965), *aff'd.* 388 F. 2d 444 (7th Cir. 1968), *cert. denied* 392 U.S. 393 U.S. 928.

DISCUSSION

Both the House Report and the Senate Report on the Tax Reform Act of 1969 make clear that the change to be effected by the Act with regard to depreciation allowed

regulated industries is a "prospective' one only. U.S. Code Cong. & Adm. News (1969), p. 1783, p. 2204-05. It is "prospective" in the sense that only property which is acquired after January 1, 1970 and which expands capacity is required to be normalized where the utility chooses to use liberalized depreciation. As to pre-1970 property and post-1969 property which does not expand capacity, both Reports declare the intent of Congress to "freeze" the existing situation regarding methods of depreciation.

Summarizing the intention of Congress as to existing property of utilities, the House Report states:

> "3. If the taxpayer is taking accelerated depreciation and flowing through to its customers the proceeds of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

In the light of the foregoing legislative history, the Commission was faced in the present case with a narrow threshhold legal question: Does the paragraph quoted above indicate an intent that the Tax Reform Act confer some additional power or mandate on the Commission to permit normalization, or is it merely a "savings" clause, which retains for the Commission its already existing regulatory powers? The Commission decided this threshhold question wrongly. It is clear, in the light of the express intent of Congress to "freeze" the situation as to existing property, that the paragraph quoted above confers no additional power on the Commission to permit an abandonment of flow through in the absence of a justifying change in factual circumstances unrelated to the effect of the Tax Reform Act itself.

In direct conflict with this legislative intent, the Commission specifically relied on the effect of the Tax Reform

Act to justify overruling earlier policy in the absence of a change in facts:

> "Furthermore, upon re-examination of the basis of our *Alabama-Tennessee* and *Midwestern* decisions in the light of the Tax Reform Act of 1969, particularly its effect on post-1969 property, and the impact of the tax law on pipeline property, the findings made in those two cases are no longer
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> applicable, and accordingly the cases are overruled to the extent they are onconsistent with this decision." Slip Opinion p. 6.

For all practical purposes, the Commission has ruled that the *inevitable* effect of the Tax Reform Act's rule as to depreciation on *post-1969 property* is to require normalization on all *pre-1970 property.* Such a result flies directly in the face of—indeed overrules—the Congressional intent to "freeze" the depreciation status of existing pipeline property.

2. To the extent that the Commission purports to rest its decision in Opinion 578 that the policy and rules of *Alabama-Tennessee, supra,* and *Midwestern, supra,* no longer obtain and must be overruled upon considerations other than the mere fact of the existence of the Tax Reform Act and its effect, such a conclusion is wholly without support in the present record.

DISCUSSION

As noted in Paragraph 1, the Committee Reports of the House and Senate make clear that the Commission may permit a change in depreciation method for existing property only to the extent that it legally could have done so in the absence of the Tax Reform Act of 1969. In the absence of the

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Tax Reform Act an overruling of the *Alabama-Tennessee* and *Midwestern* decisions, such as the Commission has made, would have to be postulated upon a finding of a change in factual circumstances which required a change in the policy of those cases, since no one disputes that natural gas companies are "required to operate with all reasonable economies." Slip Opinion P.6. The present record contains no evidence whatsoever supporting a finding that circumstances have changed substantially since the *Alabama-Tennessee* and *Midwestern* decisions, nor does the Commission point to any such change in circumstances divorced from the effect of the Tax Reform Act itself.

3. In the interest of brevity, the Philadelphia Gas Works hereby incorporates, as if set out at length, each and every one of the specific exceptions to the Commission's Opinion 578 contained in the application for rehearing of the Memphis Light & Water Division filed herein.

WHEREFORE, Philadelphia Gas Works prays that the Commission grant rehearing of its Opinion No. 578 and the accompanying Order and that upon such rehearing it vacate the said Opinion and Order and require Texas Gas to con-

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tinue the use of accelerated depreciation with flow through.

Respectfully submitted,

PHILADELPHIA GAS WORKS DIVISION
OF UGI CORPORATION

By: /s/ ROBERT W. MARIS
Robert W. Maris
Richard Bazelon
2600 The Fidelity Building
Philadelphia, Penna. 19109
Its Attorneys

dated: July 2, 1970

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

(Docketed July 17, 1970)

SETTLEMENT—Pipeline Rates

Before Commissioners: John N. Nassikas, Chairman; Lawrence J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr., and Albert B. Brooke, Jr.

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Order Approving Rate Settlement

(Issued July 17, 1970)

Texas Gas Transmission Corporation (Texas Gas), on June 12, 1970, filed a motion for approval of settlement in the above captioned proceedings, together with a Stipulation and Agreement which it proposes as the basis for settlement. Texas Gas requests that the Commission approve the Stipulation and Agreement in settlement and disposition of all issues involved in these proceedings, with the exception of tax depreciation, as described therein, which is reserved for decision by the Commission. The company requests waiver and special permissions with respect to the requirements of the Commission's Regulations to the extent necessary to effectuate all of the provisions of the Stipulation and Agreement.

The proceeding in Docket No. RP69-41 involves Texas Gas' filing of June 27, 1969, for an increase in jurisdictional rates of $36,813,407 annually, based on volumes for the twelve months ending March 31, 1969, as adjusted. The

proposed increased rates were suspended by the Commission by order issued August 11, 1969. The proposed rates, reduced by approximately $4,350,000 to reflect reductions in the company's purchased gas costs and the Federal income tax surcharge, became effective on January 12, 1970, subject to refund.[1]

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Texas Gas' filing of November 7, 1969, in Docket No. RP70-14 proposed an increase in jurisdictional rates of $5,031,437 annually over and above the rates filed in Docket No. RP69-41 and is designed solely to track the rate increase filed by its supplier, United Gas Pipe Line Company, in Docket No. RP70-13. By order issued December 15, 1969, the Commission suspended the proposed increased rates and consolidated Docket No. RP70-14 with Docket No. RP69-41. The increased rates proposed in Docket No. RP70-14, aggregating approximately $37,600,000 above the rates in effect prior to January 12, 1970, became effective on May 16, 1970, subject to refund. The proposed settlement would reduce Texas Gas' proposed rates by approximately $7,300,000 and accordingly would result in a rate increase of approximately $25,200,000 annually as of January 12, 1970, which would be increased to $30,300,000 annually as of May 16, 1970.

The proceedings were divided into two phases. The issues involved in the initial phase were rate of return and related income taxes and the question whether Texas Gas should be allowed to change from liberalized tax depreciation with flowthrough for the purpose of determining the Federal income tax allowance in the cost of service, from which its jurisdictional rates are derived. Upon motion of Staff counsel concurred in by all parties, the Commission, by notice dated December 23, 1969, waived

[1] The proposed rate increase was accordingly reduced to approximately $32,463,000 annually.

the intermediate decision on the Phase I issues. Conferences were held among Texas Gas, the interveners and the Commission Staff to explore the possibility of settlement of all issues in these proceedings. The Stipulation and Agreement which is here under consideration is the result of the various conferences.[2]

The principal provisions of the settlement proposal, which are more fully set forth in the Stipulation and Agreement, may be summarized as follows:

(1) Within ten days after the date upon which the Commission's order approving the Stipulation and Agreement

shall become final and non-appealable, Texas Gas shall: (a) file revised tariff sheets which reduce its jurisdictional rates to the levels set forth in Appendix A of the Stipulation and Agreement, effective January 12, 1970 through May 15, 1970 and refund, with interest at 8.5% annually, for that period the amounts collected in excess of the rates set forth in Appendix A; and (b) reduce its jurisdictional rates to the levels set forth in Appendix B of the Stipulation and Agreement, effective May 16, 1970, and refund, with interest at 8.0% annually, amounts collected in excess of the rates set forth in Appendix B.

(2) If, as a result of the Commission's decision and order with respect to the tax depreciation issue, Texas Gas is required to continue to use liberalized depreciation with flow-through, Texas Gas shall reduce its jurisdictional rates by $4,400,000 annually and make appropriate refunds as provided in Article II.

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[2] While the rate of return issue would be disposed of by the Stipulation and Agreement, the tax depreciation issue was determined by our Opinion No. 578 and accompanying order, issued June 3, 1970, in these proceedings.

(3) Texas Gas may increase its rates to reflect rate increases of its suppliers and shall reduce its rates to reflect supplier rate reductions, from time to time until November 1, 1971, in accordance with the provisions of Article III.

(4) Texas Gas shall refund to its jurisdictional customers the appropriate portion of any refund, together with interest thereon, received from any of its gas suppliers, which is applicable to purchases of gas by Texas Gas from such suppliers during the term of the Stipulation and Agreement, in accordance with the provisions of Article IV.

(5) Texas Gas may file to increase its jurisdictional rates to reflect the Federal income tax surcharge and if the surcharge is reduced or eliminated Texas Gas will reduce its rates accordingly but in no event below the level of a 2½% surcharge, as provided in Article VI.

(6) Except for rate filings to track supplier rate increases, the Federal income tax surcharge, or increased costs attributable to minimum Federal safety standards for the transportation of gas and pipeline facilities,

established by the Secretary of Transportation, Texas Gas will not file for an increase in its jurisdictional rates which will become effective prior to November 1, 1971, after suspension, if any.

(7) No provision of the Stipulation and Agreement shall prejudice the rights which any party may have with respect to the Commission's Opinion No. 578 and accompanying order issued June 3, 1970, relating to the tax depreciation issue in these proceedings.

Copies of Texas Gas' motion and the proposed Stipulation and Agreement were served on all parties to these proceedings, all of Texas Gas' jurisdictional customers and interested state commissions. Notice of the filing was published in the Federal Register (35 F.R. 10251). Comments and objections to the proposed settlement were filed by Memphis Light, Gas and Water Division of the City of Memphis, Tennessee (Memphis) and the Public Service Commission of the State of New York (New York) on June 30, 1970. Texas Gas filed responses thereto on July 6, 1970.

Memphis objects to the Stipulation and Agreement on the grounds that: (1) the recitation of the reserved tax depreciation issue in the Introduction is not accurate as it fails to refer to Texas Gas' request to change to straight line depreciation and consequently would prejudice Memphis' claim that the Commission's Opinion No. 578, has denied it due process by permitting liberalized depreciation with normalization rather than deciding the issue of whether Texas Gas should be required to continue on liberalized depreciation with flow-through or be allowed to utilize straight line depreciation; and (2) Article III, as presently composed, does not reflect Memphis' agreement to tracking as it would permit Texas Gas, in addition to tracking supplier price changes, to track changes in purchased gas costs attributable to changes in purchase patterns which is unlawful under the Commission's Regulations and Section 4 of the Natural Gas Act. Memphis proposes revisions in the Stipulation and Agreement consistent with its objections and also proposes that the specified levels of accumulation of Texas Gas' supplier refunds which activate its refund obligation and interest obligation thereon, respectively, be reduced and that interest accumulate from the date the specified aggregate sum of refunds exists in lieu of thirty days thereafter.

New York opposes the settlement on the grounds that it apparently is predicated on a rate of return of 8.0%, 0.5% higher than this Commission has allowed any natural gas pipeline. New York says that the 8.0% would be increased to 8.6% when consideration is given to the fact that liberalized depreciation with normalization, as authorized by Opinion No. 578, in effect allows Texas Gas an additional return of $4,400,000, the difference, as stipulated to in the proposed settlement, between liberalized depreciation with flow-through and straight line depreciation.

We do not believe that the proposed Stipulation and Agreement prejudices Memphis with respect to the issue of due process which Memphis has raised with regard to Opinion No. 578. We believe that its rights with respect to any claim it may make regarding that opinion are fully preserved by the provisions of Article XII of the Stipulation and Agreement.

Memphis' objections to the tracking provision in Article III are not well founded. Memphis states that it does not agree to the provisions of Article III because our regulations under the Natural Gas Act prohibit the inclusion of a purchased gas adjustment clause in a pipeline company's tariff. As Texas Gas points out, while we have not approved a purchased gas adjustment clause for a pipeline company, we have, as a matter of policy, permitted pipelines to track rate increases of their suppliers. We have permitted tracking primarily to eliminate the necessity for a pipeline to make a complete filing under Section 154.63 of the Regulations under the Natural Gas Act, each time one or more of its suppliers makes a price change which increases its purchased gas costs, and accordingly to reduce the number of rate filings which would otherwise be required. Memphis has construed our policy too narrowly. In adopting this policy it was not our intention

to preclude the filing of tracking increases, due to supplier price changes, which also reflect changes in purchase patterns.[8]

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Such a tracking provision is designed to permit the pipeline to recover nor more than the cost of purchased gas which it actually incurs. Furthermore, Article III is designed to cover decreases in suppliers' rates as well as increases. Article III thus is consistent with our tracking policy and at the same time would assure Texas Gas' customers of receiving the benefits of any Texas Gas' reduced gas costs due to changes in purchase pattern, whenever the tracking provision is activated. With regard to Memphis' proposed revision of the provisions of Article IV relating to refund and interest obligations it is our view that those provisions are reasonable and appropriate and that Memphis has not shown sufficient reasons for any change therein.

New York's objections are not well-taken. The Stipulation and Agreement does not specify a rate of return and we are not, by this order, approving a specific rate of return for Texas Gas. As stated in Article XII, the Stipulation and Agreement merely represents a dollar settlement with respect to Texas Gas' rates. Even assuming that the Stipulation and Agreement specified a rate of return of 8.0% or some other figure, any amounts included in Texas Gas' Federal income tax allowance in its cost of service due to the use of liberalized depreciation with normalization does not represent additional return to Texas Gas, as New York contends. The difference be-

[8] In our order issued April 28, 1969, in *Michigan Wisconsin Pipe Line Company*, Docket No. RP68-20, as amended by orders issued October 29, 1969 and March 31, 1970, we approved a rate settlement which provided for a tracking provision similar to that contained in Article III of the Stipulation and Agreement herein, in that it permits tracking filings which reflect changes in purchase patterns.

tween taxes collected through its rates and taxes actually paid would be credited to Account 282, Accumulated Deferred Income Taxes—Liberalized Depreciation and would remain available as a contingency reserve for the payment of income taxes which in any future year might be greater because of the prior use of liberalized depreciation. Moreover, no return would be allowed on the balances accumulated in Account 282 as they would be deducted from the rate base in accordance with our Opinion No. 578.

For the reasons stated above we conclude that the objections of Memphis and New York are without merit and do not require any revisions to the Stipulation and Agreement as proposed.

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Based upon our review of the terms and provisions of the Stipulation and Agreement, the objections and responses thereto, and the record in these proceedings, we conclude that the proposed settlement provides a reasonable and appropriate disposition of the issues herein.

The Commission finds:

The settlement of these proceedings on the basis of the Stipulation and Agreement submitted by Texas Gas on June 12, 1970, is reasonable and proper and in the public interest in carrying out the provisions of the Natural Gas Act, and should be approved and made effective.

The Commission orders:

(A) The Stipulation and Agreement submitted by Texas Gas on June 12, 1970, and incorporated herein by reference, is approved and made effective.

(B) Texas Gas shall fully comply with each of the provisions of the Stipulation and Agreement and of this order.

(C) This order is without prejudice to any findings or orders which have been made or may hereafter be made by the Commission, and is without prejudice to any claims or contentions which may be made by the Commission, its Staff, Texas Gas, or any other party or person affected by this order, in any proceeding now pending or hereafter instituted by or against Texas Gas or any other person or party.

By the Commission.

(SEAL)

GORDON M. GRANT,
Secretary.

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Opinion No. 578-A

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Opinion and Order Denying Rehearing

Issued: July 21, 1970

DC-53

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(Issued July 21, 1970)

NASSIKAS, Chairman:

1. The Memphis Light, Gas & Water Division (Memphis) on June 29, 1970, the Public Service Commission of the State of New York (New York) on July 2, 1970, and the Philadelphia Gas Works Division of UGI Corporation (PGW) on July 6, 1970,[1] have filed applications for

[1] July 3, 4, and 5, 1970, were United States Government holidays.

rehearing with respect to our Opinion No. 578 and order issued June 3, 1970, in the above-entitled proceeding. In Opinion No. 578 and order we permitted Texas Gas Transmission Corporation to use liberalized depreciation with normalization with respect to property other than its post-1969 property, which is subject to election under Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, to abandon use of liberalized depreciation for tax purposes. Under our Order No. 404, Statement of Policy, issued May 15, 1970, instead of reverting to straight-line depreciation the electric or natural gas pipeline company making the election is permitted to employ the normalization method for accounting as well as ratemaking. In most cases the points made on rehearing have been considered in Opinion No. 578, and any further discussion would be superfluous, but in other cases additional comments, in our opinion, would indicate more clearly the basis of our opinion.

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2. Memphis and New York contend that we deprive them of due process of law in permitting Texas Gas to adopt liberalized depreciation with normalization for the non-elective properties. New York says the sole depreciation issue was whether Texas Gas should be granted permission to abandon liberalized depreciation with flow-through in order to change to straight-line depreciation for tax purposes. The Presiding Examiner provided that the hearing should be phased in accordance with our order of August 11, 1969, 42 FPC 511. He stated that "In Phase I the issues of rate of return and related income tax will be tried, and the issue of the return from accelerated to straight-line depreciation, insofar as the principle thereof is involved" (Tr. 69-70). The Tax Reform Act and our Order No. 404 dealt with the property subject to election. With respect to the property not subject to election it seems clear that, if properly supported by the record, we could deny Texas Gas' request to depart from liberalized

depreciation, or we could grant it. We could also prescribe other solutions to the problem. In this instance the use by Texas Gas of liberalized depreciation with normalization, while it increases the tax costs to its customers, has some advantages over a reversion to straight-line depreciation for tax purposes. Normalization, as our opinion indicates, would improve the company's cash position, would, in effect, provide it with an interest free fund, and, because of the deduction of the accumulated reserves in Account 282 from the rate base, would reduce the company's cost of service and benefit consumers. This is a solution which we find more in the public interest than reversion to straight-line depreciation, and we could have treated Texas Gas for ratemaking purposes as though it were following this course. Compare *Midwestern Gas Transmission Co.*, 36 FPC 61 (1961), aff'd 388 F. 2d 444 (7th Cir.), *cert. denied* 392 U.S. 928 (1968). Therefore the letter from Counsel for Texas Gas dated May 22, 1970, which we quote in our original opinion, does not change the nature of the proceedings or introduce a new issue. It merely shows that the company does not oppose the solution which we find preferable.

3. New York argues that there are relationships between the tax depreciation issue and the rate of return allowance, so that the Commission was not free to decide one of the issues without deciding the other. As explained in Opinion No. 578 the rate of return issue was subject to settlement negotiations which have now resulted in a settlement approved by the

Commission. In that order it is pointed out that use of liberalized depreciation with normalization does not represent additional return to Texas Gas.

4. Memphis and New York also argue that we improperly founded our determination on management discretion. This

was not our purpose. Because of the election authorized by the Tax Reform Act it is our opinion, as expressed in Opinion No. 578, that tax costs under the flow-through method could increase in the future with undesirable rate consequences. While our findings and conclusions were supported by the judgment of management, we were not basing them on management discretion but on our own judgment of the facts and the law.

5. They argue, further, that the Tax Reform Act or its legislative history do not permit or require us to allow the use of liberalized depreciation with normalization. Section 441 of the Tax Reform Act, it is true, does not require a change from flow-through to normalization, but providing an election with respect to post-1969 property changes the economic conditions with respect to the use of flow-through on existing property. New York quotes the Conference Report [3] to the effect that a taxpayer is not permitted to use accelerated depreciation unless it uses normalization but that this rule does not apply to a taxpayer presently using flow-through. However, this is not inconsistent with our permitting a change from flow-through to normalization.

6. PGW argues similarly that the Tax Reform Act did not confer on us additional power to permit an abandonment of flow-through in the absence of a justifying change in factual circumstances unrelated to the effect of the Tax Reform Act. We see no reason why the impact of the Tax Reform Act may not be a circumstance that might militate in favor of permitting Texas Gas to abandon flow-through accounting. As already noted, the Tax Reform Act permits the company to abandon flow-through with respect to post-1969 elective property. This changes

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[3] Conference Report No. 91-782, U. S. Code Congressional and Administrative News, p. A-785.

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the effect of liberalized depreciation with flow-through on the Company and its customers. For the reasons set forth in Opinion No. 578 we accordingly permitted Texas Gas to abandon flow-through for ratemaking and accounting and employ normalization.

The Commission further finds:

The assignments of error and grounds for rehearing set forth in the above applications for rehearing and motions for stay present no facts or legal principles which would warrant any change in or modification of Opinion No. 578 and order of June 3, 1970.

The Commission orders:

The applications for rehearing filed by Memphis, New York and PGW are denied.

By the Commission.

(SEAL)

GORDON M. GRANT,
Secretary.

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. ____

FEDERAL POWER COMMISSION, PETITIONER

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The Solicitor General, on behalf of the Federal Power Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINIONS BELOW

The initial opinion of the court of appeals (App. A, *infra*, pp. 17–39) and its opinion on rehearing (App. B, *infra*, pp. 41–53) are not yet reported. The initial opinion (No. 578) of the Federal Power Commission (App. D, *infra*, pp. 57–66) and its opinion on rehearing (No. 578–A; App. E, *infra*, pp. 67–71) are reported at 43 FPC 824 and 44 FPC 140.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972 (App. C, *infra*, pp. 55–56), and the Commission's petition for rehearing was denied on May 11, 1972 (App. B, *infra*, pp. 41–53). On August 4, 1972, the Chief Justice extended the time for filing a petition for a writ of certiorari to September 23, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 625, 26 U.S.C. 167(l), is set forth in App. F, *infra*, pp. 73–78.

QUESTION PRESENTED

Whether, in enacting Section 441(a) of the Tax Reform Act of 1969, Congress intended to withdraw from the Federal Power Commission and other agencies charged with similar regulatory responsibilities the authority to permit a utility, in calculating its federal income tax allowance for ratemaking purposes, to conform its method of computing depreciation on its other property to the method it had elected under the Act to be applicable to its post-1969 expansion property.[1]

[1] If this Court grants certiorari, we intend to argue further that, assuming Section 441(a) did not affect the Commission's authority to permit a utility to conform its depreciation methods, the Commission's action in this case was proper and should be affirmed without further proceedings in the court of appeals.

STATEMENT

It has long been established that federal income taxes are properly includable as an expense under the cost of service method of ratemaking utilized by the Federal Power Commission in the regulation of rates for sales of natural gas subject to its jurisdiction under the Natural Gas Act, 15 U.S.C. 717, *et seq.* The method of calculating such taxes for ratemaking purposes, however, may not be the same as the method used for calculating the taxes actually paid. In the instant rate proceeding, the Commission determined that nothing in Section 441(a) of the Tax Reform Act of 1969, 26 U.S.C. 167(*l*)—which Section specifies the depreciation methods utilities may use in calculating their federal income taxes—deprives it of the authority to permit a company subject to its jurisdiction to shift from liberalized depreciation with flow-through to liberalized depreciation with normalization[1] with respect to pre-1970 property and post-1969 replacement property (collectively referred to herein-

[1] Under flow-through, a utility using liberalized (accelerated) depreciation in calculating its actual taxes, also uses liberalized depreciation in calculating its tax expense for ratemaking purposes. Actual current tax savings are thus "flowed-through" to the utility's customers. Under normalization, taxes for ratemaking purposes are computed using straight-line depreciation although the utility uses liberalized depreciation in calculating the taxes it actually pays. The difference between the taxes that would have been paid under straight-line depreciation and the actual taxes based on liberalized depreciation is put into a deferred tax reserve account by the utility to pay future taxes.

Not involved in this proceeding is the accounting method used by the utility for calculating depreciation as a separate, non-tax expense to be reflected in establishing rates.

after as "existing property"). Focusing on a provision in Section 441(a) of the Act which by its terms applies only to post-1969 expansion property (26 U.S.C. 167(*l*)(4)(A)), the court of appeals reversed the Commission.

A. BACKGROUND

With the adoption of Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, companies for the first time were authorized to use liberalized or accelerated depreciation in calculating their federal income taxes. The Commission at first determined that the use of liberalized depreciation merely resulted in a tax deferral and, to avoid benefiting the present customers of a utility at the expense of later customers who would have to pay the deferred taxes, the Commission decided that the income tax expense allowed as a cost of service for ratemaking purposes should be normalized—*i.e.*, computed as if the company were using straight-line depreciation. See *Amere Gas Utilities Co.*, 15 FPC 760, 781; *Cities of Lexington, etc., Ky.* v. *Federal Power Commission*, 295 F.2d 109, 114 (C.A. 4).

In *Alabama-Tennessee Natural Gas Co.*, 31 FPC

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[1] Section 441(a) of the Tax Reform Act added subsection (*l*) to Section 167 of the Internal Revenue Code, 26 U.S.C. 167(*l*). Section 167(*l*)(3)(B) and (C) distinguishes between pre-1970 property, or property acquired before January 1, 1970, and post-1969 property, or property acquired on January 1, 1970, or after. Section 167(*l*)(4)(A) establishes an additional category of post-1969 property which "increases the productive or operational capacity of the taxpayer * * * and does not represent the replacement of existing capacity," referred to hereinafter as "expansion property."

308, affirmed *sub nom. Alabama-Tennessee Natural Gas Co. v. Federal Power Commission*, 359 F.2d 318 (C.A. 5), certiorari denied, 385 U.S. 847, the Commission reconsidered the issue and found that the use of liberalized depreciation by utilities usually resulted in permanent tax savings since most utilities had growing or stable plant investments.[4] Accordingly, the Commission ordered utilities using liberalized depreciation to flow-through to their customers the resultant tax savings.[5] Finally, in *Midwestern Gas Transmission Co.*, 36 FPC 61, affirmed *sub nom. Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444 (C.A. 7), certiorari denied, 392 U.S. 928, the Commission held that for rate-making purposes it would impute the use of liberalized tax depreciation to any company which shifted from liberalized tax depreciation to straight-line depreciation and would flow through the resulting imputed tax savings to the company's customers.

B. SECTION 441(a) OF THE TAX REFORM ACT OF 1969

In considering tax reform legislation in 1969, the House Ways and Means Committee expressed concern over the loss of tax revenues resulting from shifting by regulated utilities either from straight-

[4] A growing company using liberalized depreciation generally has enough new and replacement property to generate sufficient depreciation allowances to offset the declining depreciation allowances on its existing property.

[5] In the same case, the Commission initiated the policy now in effect that the deferred tax reserve accumulated by a utility that had been using normalization must be deducted from the utility's rate base so that no return on the tax savings would be included in its rates. 31 FPC at 220–221.

line depreciation to liberalized depreciation or from liberalized depreciation with normalization to liberalized depreciation with flow-through; the committee also cited with disapproval the practice of several regulatory agencies of imputing for ratemaking purposes the use of liberalized depreciation with flow-through to utilities using straight-line depreciation for tax purposes. H. Rep. No. 91-413, 91st Cong., 1st Sess., pp. 131-132. On the other hand, the House committee rejected suggestions by the Commission and others that all utilities using liberalized depreciation be required to change to straight-line depreciation, since such a rule would place some utilities at a competitive disadvantage and would result in substantial rate increases (*id.* at 132). Accordingly, the committee proposed and the House passed a "freeze" on existing depreciation practices subject to the following three general rules (*id.* at 133):

> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.
>
> (2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.

The Senate Committee on Finance, while also expressing concern over the loss of tax revenues from utility depreciation practices, similarly rejected a requirement that all utilities revert to straight-line depreciation. S. Rep. No. 91–552, 91st Cong., 1st Sess., pp. 172–173. The committee proposed and the Senate passed legislation similar to the House bill, except that utilities on flow-through were given the right to elect within 180 days of the enactment of the bill

> * * * to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or * * * with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill). [*Id.* at 173.]

In conference, the Senate bill was amended to limit the right of election to expansion property. See H. Conf. Rep. No. 91–782, 91st Cong., 1st Sess., pp. 312–313. As thus amended, the depreciation provisions were enacted as Section 441(a) of the Tax Reform Act of 1969.

C. PROCEEDINGS BEFORE THE COMMISSION

Following enactment of the Tax Reform Act of 1969, the Texas Gas Transmission Corporation, in the context of pending rate proceedings, advised the Commission of its intent to elect under Section 441(a) of the Act to abandon flow-through with respect to its expansion property and, with the Commission's permission, to use liberalized depreciation with normalization with respect to such property in computing its

federal income tax (App. D, *infra*, p. 59). Before it made the election, however, Texas Gas sought permission to change from flow-through to straight-line depreciation or, preferably, liberalized depreciation with normalization with respect to its existing property (*ibid.*).

In Order No. 404, 43 FPC 740, rehearing denied, 44 FPC 16, the Commission announced that as a general policy it would permit utilities making the election under Section 441(a) of the Tax Reform Act to use liberalized depreciation with normalization with respect to their expansion property.

Subsequently, the Commission issued Opinion No. 578 in Texas Gas' pending rate proceedings permitting Texas Gas to shift to liberalized depreciation with normalization with respect to all its property (App. D, *infra*, pp. 57–66). The Commission found that once Texas Gas had elected to abandon flow-through with respect to its expansion property, the continued use of flow-through with respect to its existing property would result in a steadily increasing tax expense for ratemaking purposes, since liberalized depreciation on new facilities would no longer be available to offset declining depreciation on existing facilities (App. D, *infra*, pp. 62–63). The Commission concluded that the use of normalization with respect to Texas Gas' existing property was necessary to promote stable rates (App. D, *infra*, p. 63).

In accordance with its established practice (see n. 5, *supra*), the Commission required Texas Gas to put the difference between the taxes actually paid and the taxes that would have been paid under

straight-line depreciation (and are claimed as a cost of service for ratemaking purposes) into a deferred tax reserve. The reserve was required to be deducted from the rate base so that the company would not earn any return on the reserve (App. D, *infra*, p. 65).[6]

D. THE DECISION BELOW

Petitions for review were filed with respect to both Order No. 404 and Opinion 578 and were consolidated by the court of appeals. The court upheld the Commission's decision in Order No. 404 to permit utilities electing to abandon flow-through with respect to their expansion property to use liberalized depreciation with normalization on such property (App. A, *infra*, pp. 20–29).[7]

The court below reversed the Commission, however, with respect to Opinion No. 578; it held that Section 441(a) of the Tax Reform Act deprived the Commission of authority to permit utilities to abandon flow-through with respect to their existing property (App. A, *infra*, pp. 29–39). The court recognized that the original version of the legislation adopted by the House did not limit this authority, but construed the election provision proposed by the Senate and nar-

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[6] Texas Gas' customers would thus benefit indirectly from the use of liberalized depreciation with normalization, since the reserve provides the company with capital for the expansion of facilities or the improvement of service at no cost to the customers.

[7] A petition for a writ of certiorari to review this aspect of the decision below is pending. *Memphis Light, Gas and Water Division* v. *Federal Power Commission, et al.*, No. 72-96. We have filed a brief in opposition to the petition.

rowed in conference as a limitation on the House bill (App. A, *infra*, pp. 31–34). In denying petitions for rehearing, the court reaffirmed its interpretation of Section 441(a) and its legislative history (App. B, *infra*, pp. 41–53).

REASONS FOR GRANTING THE WRIT

The decision below erroneously construes Section 441(a) of the Tax Reform Act of 1969 to prohibit the Federal Power Commission from permitting a utility, in calculating its federal income tax allowable as a cost of service for ratemaking purposes, to conform its method of computing depreciation on existing property to its method of computing depreciation on expansion property. The decision seriously impairs the ability of the Commission and other regulatory agencies[*] to prescribe rational accounting practices and promote stable rates. Accordingly, review by this Court is warranted.

1. Prior to the enactment of the Tax Reform Act of 1969, the Commission exercised broad authority over the methods that electric utilities and natural gas companies subject to its jurisdiction employed to compute depreciation in calculating federal income taxes as a cost of service for ratemaking purposes (see pp. 4–5, *supra*). While Section 441(a) of the 1969 Act

[*] Section 441(a) applies to all property used predominantly to furnish or sell (1) electric energy, water or sewage disposal services, (2) gas or steam through a local distribution system, (3) telephone and certain other communication services, and (4) transportation of gas or steam by pipeline, if the rates for such services are regulated. 26 U.S.C. 167(*l*)(3)(A).

restricts that authority in certain respects,' neither the statute nor its legislative history supports the restriction on the Commission's authority over accounting practices with respect to existing properties imposed by the court of appeals.

As we have noted (see p. 6, *supra*), the initial House version of Section 441(a) embodied three general rules with respect to depreciation practices, the third of which required a utility using liberalized depreciation with flow-through on its existing property to continue using that method of depreciation, "unless the appropriate regulatory agency permits a change as to that property." H. Rep. No. 91-413, *supra*, p. 133. The Senate report makes clear that the Senate amendments followed the House bill with respect to existing property, except that the Senate also gave utilities the right to elect to abandon flow-through. The Senate report states (S. Rep. No. 91-552, *supra*, pp. 172-173):

> Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:
>
> * * * * *
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which

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*The election provision in Section 441(a), 26 U.S.C. 167(*l*)(4)(A), for example, prohibits the Commission from imputing the use of liberalized depreciation with flow-through for expansion property to utilities electing to abandon flow-through with respect to such property. See our brief in opposition in No. 72-96 (n. 7, *supra*).

are discussed below), unless the appropriate regulatory agency permits a change as to that property.

The parenthetical reference is to the right of election. In other words, the right of election adopted by the Senate simply provides an additional procedure whereby utilities may get off flow-through with respect to existing property, but does not restrict the authority of regulatory agencies generally to permit the abandonment of flow-through. Thus, when the conference restricted the right of election to expansion property, but otherwise followed the Senate amendments (H. Conf. Rep. No. 91-782, *supra*, pp. 312-313), it did not disturb the regulatory authority recognized by the general rules referred to in the House and Senate reports. See General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172, prepared by the staff of the Joint Committee on Internal Revenue Taxation, p. 153."

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[10] As finally enacted, Section 441(a) adds a new subsection (*l*) to Section 167 of the Internal Revenue Code of 1954, 26 U.S.C. 167(*l*), prescribing what constitutes a "reasonable allowance" for depreciation of public utility property for computing the depreciation deduction under Section 167(a). Under Section 167(*l*)(1), a "reasonable allowance" for pre-1970 property is an allowance computed under either (1) a "subsection (*l*)" (essentially straight-line, see Section 167(*l*)(3)(F)) method, (2) the method used prior to the enactment of the bill if the company uses normalization, or (3) accelerated depreciation with flow-through if the company used flow-through on such property prior to the enactment of the bill. Under Section 167(*l*)(2), a "reasonable allowance" for post-1969 property is an allowance computed in one of three ways: (1) under a "subsection (*l*)" method, (2) under accelerated depreciation with normalization or (3) under accelerated

In reaching the contrary conclusion, the court below placed greater emphasis (App. A, *infra*, p. 33) on the following sentence in the second paragraph of the Conference report's discussion of the depreciation provisions (H. Conf. Rep. No. 91–782, *supra*, p. 312):

> This rule [that a taxpayer cannot use accelerated depreciation unless it normalizes] is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account.

The court construed "This rule" to refer to the final version of the statute as approved by the conference and thus concluded that there was no way a utility could get off flow-through with respect to existing property. A close reading of the report, however, discloses that "This rule" does not refer to the final bill, but refers to the initial House bill summarized in the first two paragraphs of the report's discussion of the depreciation provisions; the third paragraph discusses the Senate amendments and only the fourth paragraph explains the conference modifications of the legislation. When the first two paragraphs are read together, the above-quoted sentence is seen to state merely that a company on flow-through *may* remain on flow-through; it does *not* state—what even the court below conceded the House bill did not provide—that a company on flow-through could not

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depreciation with flow-through if the utility used flow-through on similar property prior to the enactment of the bill. Under the election provision, Section 167(*l*)(4)(A), a utility may elect not to have the third option (accelerated depreciation with flow-through) apply to its post-1969 expansion property.

abandon flow-through with respect to its existing property with the permission of the appropriate regulatory agency.

The court below also emphasized the statements in the House and Senate reports that the proposed legislation was intended to "freeze" the current situation regarding methods of depreciation (App. A, *infra*, pp. 34-35). This emphasis is misplaced and does not support the decision below. As shown above, both reports specifically indicate that a utility may abandon accelerated depreciation with flow-through on existing property with the permission of the appropriate regulatory agency. Thus, while Congress imposed a "freeze" so that utilities would not be required to abandon flow-through and force automatic rate increases, it did not deny regulatory agencies the authority to determine whether in particular instances the abandonment of flow-through accounting is in the public interest.

2. In this case, the Commission properly concluded that it was not in the public interest for Texas Gas to compute its federal tax expense for ratemaking purposes using normalization on expansion property and flow-through on existing property. If the different methods of depreciation were used, liberalized depreciation on expansion facilities would no longer be available to offset declining depreciation on existing facilities.[11] As a result, the depreciation deduction

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[11] As we have noted, "existing property" includes replacement property (see n. 3, *supra*). Liberalized depreciation on replacements would not offset declining depreciation on the property remaining in service, however, since the nature of

would steadily decrease and the tax expense for rate-making purposes would increase necessitating periodic rate increases. In these circumstances, it was well within the competence and authority of the Federal Power Commission to determine that the use of the same method of depreciation for both expansion and existing property, while perhaps necessitating present rate increases (rather than deferral to future consumers of payments for present tax expenses), would promote stable rates and would be in the public interest.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 1972.

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the pipelines and other equipment used by the natural gas industry is such that replacements are relatively infrequent and may not be necessary until well after an asset is fully depreciated (see App. D, *infra*, pp. 62–63).

APPENDIX A

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 24,517

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION,
TENNESSEE VALLEY MUNICIPAL GAS ASSOC., ETC., INTERVENORS

No. 24,518

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION,
AMERICAN PUBLIC GAS ASSOCIATION, INTERVENORS

No. 24,602

TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

No. 24,632

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

Petitions for Review of Orders of the Federal Power Commission

Decided February 18, 1972

Mr. George E. Morrow, with whom *Mr. Reuben Goldberg* was on the briefs, for petitioner in Nos. 24,517 and 24,518.

Mr. Morton L. Simons for petitioner in No. 24,632.

Mr. J. Richard Tiano, Assistant Solicitor, Federal Power Commission, with whom *Messrs. Gordon Gooch*, General

Counsel, and *Abraham R. Spalter*, Assistant General Counsel, Federal Power Commission, were on the brief, for respondent. *Mr. Israel Convisser*, Attorney, Federal Power Commission, also entered an appearance for respondent.

Mr. Christopher T. Boland, with whom *Mr. Richard J. Connor* was on the brief, for intervenor Texas Gas Transmission Corporation. *Mr. George J. Meiburger* also entered an appearance for intervenor Texas Gas Transmission Corporation in Nos. 24,517 & 24,518.

Mr. Reuben Goldberg entered an appearance for petitioner in No. 24,602.

Mr. Charles F. Wheatley, Jr., was on the brief for intervenor American Public Gas Association in No. 24,518.

Before FAHY, *Senior Circuit Judge*, and ROBINSON and WILKEY, *Circuit Judges*.

WILKEY, *Circuit Judge*: These two sets of cases, consolidated for review, involve a determination as to the impact of Section 441(a) of the Tax Reform Act of 1969,[1] relating to the methods of depreciation for regulated utilities, on two types of utility property: (1) post-1969 expansion property and (2) pre-1970 and post-1969 non-expansion property.[2] The impact of Section 441(a) on post-1969 ex-

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[1] Int. Rev. Code of 1954, § 167(l), *as amended* Publ. L. 90-26, §§ 1, 2(b), 81 Stat. 57, 58 (1967); Publ. L. 91-172, § 521 (a), (d), 83 Stat. 625, 649, 653 (1969).

[2] Section 441(a) of the 1969 Tax Reform Act defines "pre-1970" property as "property which was public utility property in the hands of any person at any time before January 1, 1970." [Int. Rev. Code of 1954, § 167(l)(3)(B)]. Property which is not pre-1970 is considered "post-1969" property [Int. Rev. Code of 1954, § 167 (l)(3)(C)]. "Expansion" property is the term employed to denote that property "which increases the productive or operational capacity of the taxpayer," while "non-expansion" property refers simply to

pansion property—the subject of FPC Orders No. 404 and 404-A, issued, respectively, 15 May 1970 and 9 July 1970, and cases no. 24,518 and 24,602 here—will be considered first, followed by a determination of its effect on pre-1970 and post-1969 non-expansion property—the subject of FPC Opinions No. 578 and 578-A and accompanying orders, issued 3 June 1970 and 21 July 1970, respectively, and cases no. 24,517 and 24,632 here.

I.

A.

Congress specifically provided for the proper depreciation treatment of post-1969 utility expansion property in Section 441(a) of the Tax Reform Act of 1969 as follows:

> (A) *Election as to new property representing growth in capacity.*—If the taxpayer makes an election under this subparagraph within 180 days after the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) [concerning liberalized depreciation with flow-through] shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.[1]

This provision indicates that Congress intended to, and did, prescribe specifically the appropriate tax depreciation treatment for post-1969 expansion property of utilities such as involved in the cases here. It permits a regulated utility such as Texas Gas Transmission Corporation,

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that property which replaces the existing plant of a taxpayer [Int. Rev. Code of 1954 § 167(1)(4)(A)].

[1] Int. Rev. Code of 1954, § 167(1)(4)(A).

an intervenor in these cases, to make an election, within 180 days after enactment of this provision, *not* to have liberalized depreciation with flow-through[4] apply with respect to its post-1969 expansion property. That is, such a method would no longer be considered a "reasonable allowance" for tax depreciation purposes within the meaning of the Internal Revenue Code of 1954.[5]

The legislative history accompanying Section 441(a) of the 1969 Tax Reform Act supports this interpretation. The report of the Senate Finance Committee states in relevant part:

> The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, *with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method* (that is, come under general rules of the bill).
>
> *This election applies both as to new and existing property.* . . . Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency

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[4] By utilizing liberalized depreciation in computing its income tax, a utility obtains a larger deduction, and thus pays less income tax, at least initially, and, in the case of expanding or steady plants, overall, than it would if it used straight-line depreciation. Under the "flow-through" method of liberalized depreciation, a utility is allowed to recoup from its customers by means of its rates only the taxes it *actually* pays; under "normalization," however, it is allowed to recoup the higher taxes it would pay (but actually does not) if it were using straight-line depreciation.

[5] Int. Rev. Code of 1954, § 167(1)(2)(C).

would not be able to impute the use of accelerated depreciation with flow-through.[6]

In conference, the *election right was restricted to apply only to post-1969 expansion property.* As the Conference Report indicates:

> The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) *follows the Senate amendment except that* the special provision referred to in (e) above is stricken and *the 180-day election (item (d), above) is modified to apply to new property and not to replacement property.* Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company.[7]

It is clear, then, that Congress intended to, and did in fact, provide regulated utilities such as Texas Gas with an option to abandon flow-through for rate-making purposes in regard to post-1969 expansion property and substitute in its place either (1) straight-line depreciation, with or without the permission of the relevant regulatory agency or (2) accelerated depreciation with normalization,[8] with

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[6] S. Rep. No. 552, 91st Cong., 1st Sess. 173-74 (1969) (emphasis added).

[7] Conf. Rep. No. 782, 91st Cong., 1st Sess. 312-13 (1969) (emphasis added).

[8] Under normalization, taxes for *ratemaking purposes* are determined on the basis of straight-line depreciation, while for *tax purposes* liberalized depreciation is used. The differences between the taxes which would be payable under straight-line depreciation and the taxes payable under liberalized depreciation is placed into a deferred tax reserve account by the taxpayer. The FPC requires that this reserve account be deducted from the rate base. Accordingly, the rates charged customers are lower by the amount of the return on this reserve account which would otherwise be charged if the reserve account were not deducted from the rate base.

the permission of the appropriate regulatory agency. It is also clear that Congress intended thereby to preclude regulatory agencies from imputing flow-through to any regulated utility exercising this election with respect to its post-1969 expansion property.[9]

B.

The basic issue in this set of cases, therefore, is whether the FPC was correct in its Orders No. 404 and 404-A in interpreting the Tax Reform Act of 1969 as depriving it of the power to impute the use of liberalized depreciation with flow-through for rate-making purposes to a utility making the election under Section 441(a)[10] to abandon flow-through with respect to its post-1969 expansion property. Clearly, it is the duty of the FPC, under its Congressional mandate, the Natural Gas Act,[11] to ensure the

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[9] As the Senate Finance Committee Report states with respect to a company exercising its right to abandon flow-through under the 180-day election provision, ". . . Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), *the agency would not be able to impute the use of accelerated depreciation with flow-through.*" [See note 6, *supra*, at 174 (emphasis added)] While the availability of the 180-day election option was subsequently limited in conference to apply only to post-1969 utility expansion property, the Conference Report stated that "[t]he conference substitute (Sec. 441 of the substitute and Sec. 167(1) of the code) *follows the Senate amendment* except that "the 180-day election . . . is modified to apply to new property and not to replacement property." [See note 7, *supra* (emphasis added)] This indicates that the Senate rationale, cited above, is controlling as to post-1969 expansion property, thus preventing the Commission from imputing liberalized depreciation with flow-through to Texas Gas' post-1969 expansion property.

[10] See note 8, *supra*.

[11] 15 U.S.C. §§ 717-717(w) (1954).

continued availability of natural gas in interstate commerce for eventual sale to consumers at the lowest practicable rate. As the Fifth Circuit had occasion to observe:

> The central principle in the regulation of the natural gas industry around which all ratemaking revolves is "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption . . . at the lowest possible reasonable rate consistent with the maintenance of adequate service on the public interest."

This is the language of Section 7(c) of the Natural Gas Act as originally enacted in 1938. The provision was deleted when the subsection was amended in 1942 but, as the Supreme Court has held, the amendment was not intended to change the congressional purpose of the Act; the "primary aim of this legislation was to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission* v. *Hope Natural Gas Company*, 1944, . . . Again, as Justice Clark reiterated twenty-five years later: "The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining Company* v. *Public Service Commission*, 1959, . . .[12]

However, the FPC may not remain oblivious to the wishes of Congress as expressed in forms other than amendments to or deletions from the Natural Gas Act. By means of Section 441(a) of the 1969 Tax Reform Act, Congress has provided regulated utilities such as Texas Gas with an absolute right of election to abandon flow-through with respect to their post-1969 expansion property. Furthermore, we do not have the situation presented in *Alabama-Tennessee Natural Gas Co.* v. *FPC*,

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[12] *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F.2d 318, 331 (5th Cir.), *cert. denied* 385 U.S. 847 (1966).

supra, where the court was able to find "no evidence that at the time Section 167 [of the Internal Revenue Code] was enacted Congress even focused on the problem in terms of reducing the dimensions of the Federal Power Commission's regulatory responsibility to protect consumers from excessive rates. . . ."[12] Rather, investigation of the legislative history regarding Section 441(a) of the Tax Reform Act of 1969 reveals that Congress was well aware of the implications of permitting regulated utilities an election to abandon liberalized depreciation with flow-through with respect to the their post-1969 expansion property.[14] As such, the FPC was not remiss in the performance of its statutory duty in permitting Texas Gas to abandon flow-through in regard to its post-1969 expansion property, as expressly provided by the language of Section 441(a) of the 1969 Tax Reform Act.

C.

The FPC's Orders No. 404 and 404-A, indicating that it would continue the policy adopted in *Alabama-Tennessee Natural Gas Co., supra*,[15] of deducting the amounts in the accrued deferred tax account from the rate base and not considering such balances as part of capitalization in rate proceedings before it, is a statement of policy based essentially on an interpretation of Section 441(a) of the 1969 Tax Reform Act. Thus, under the pertinent provi-

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[12] *Id.*, at 332. As the court also observed, "Occam's razor slices through the arguments based on legislative history and congressional intent. Either Congress did not consider the concrete problem the case presents or, if it did, Congress decided to let sleeping dogs lie." [*Id.*, at 336]

[13] See notes 6 & 7, *supra*.

[14] 34 FPC 208, *modified* 31 FPC 923 (1964), *aff'd sub nom. Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, see note 12, *supra*.

sions of the Administrative Procedure Act,[16] it was properly issued without notice or opportunity for hearing, since it was not the result of a rulemaking proceeding.

While Memphis Light contends that Orders No. 404 and 404-A of the Commission denied them the benefits of liberalized depreciation with flow-through accounting and ratemaking in regard to their post-1969 expansion property, they misdirect their attack. Instead of the Commission's orders here, what resulted in the denial of liberalized depreciation with flow-through was the election by Texas Gas to abandon such depreciation, as it was specifically entitled to do under Section 441(a) of the 1969 Tax Reform Act. Texas Gas made this election in a letter to the Commissioner of Internal Revenue dated 8 June 1970, a copy of which was transmitted to the FPC dated 10 June 1970. At this juncture, the *only* options available to the Commission were either to do nothing and thereby leave Texas Gas on straight-line depreciation or to permit it to use liberalized depreciation with normalization. And the FPC chose the latter.

The Commission's Orders No. 404 and 404-A, then, were nothing more than statements of FPC policy interpreting the mandate of Congress as expressed in Section 441(a) of the Tax Reform Act of 1969. As such, they were clearly exempt from the notice and opportunity for hearing requirements for rulemaking provided under the Administrative Procedure Act. While it is true that the FPC's interpretative rulings here may have significant economic consequences on Memphis Light and other ratepayers in the long run, such a statement of policy is specifically exempted by the Administrative Procedure Act from the need for prior notice or opportunity for a hearing:

> Except when notice or hearing is required by statute [not relevant here], this subsection does not apply—

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[16] 5 U.S.C. § 553(b)(A) (1966).

(A) to interpretative rules, *general statements of policy*, or rules of agency organization, procedure, or practice. . . ."[17]

D.

The case law does not support the petitioners' assertion that notice and opportunity for hearing were required in this set of cases—24,518 and 24,602. While interested parties might argue the validity of the FPC's interpretation of Congressional purpose as expressed in Section 441(a) of the Tax Reform Act of 1969, such an opportunity is not required by the Administrative Procedure Act prior to issuance of such interpretations by an administrative agency.[18]

The petitioners' argument that the FPC, as a result of the issuance of its Orders No. 404 and 404-A, has changed its policy in *Alabama-Tennessee Natural Gas Co., supra*, is incorrect. Only those utilities that made the election provided by Section 441(a) of the 1969 Tax Reform Act to abandon flow-through with respect to their post-1969 expansion property are affected by the Commission orders here at issue. The case of *Texaco, Inc.* v. *FPC*[19] is inapposite, since the switch from simple to compound interest which the Commission ordered in that case was one involving consideration of, *inter alia*, current interest rates and trends, the impact on individual companies and the effect of increased contingent liabilities on the ability of the companies affected to acquire new equity or debt capital. In contrast, the instant set of cases, aside from the question of the validity of the FPC's interpretation of

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[17] *Id.* (emphasis added).

[18] *See Id.*; also, *Gibson Wine Co.* v. *Snyder*, 90 U.S. App. D.C. 135, 194 F.2d 329 (1952); *Garelick Manufacture Co.* v. *Dillon*, 114 U.S. App. D.C. 218, 313 F.2d 899 (1963).

[19] 412 F.2d 740 (3rd Cir. 1969).

Section 441(a) of the 1969 Tax Reform Act, involved no need for further consideration by the Commission as to what regulatory policy would result in a lower rate for Memphis Light and other ratepayers. The impact of liberalized depreciation with normalization as opposed to that of straight-line depreciation—the only choice open to the FPC under the election provision for regulated utilities such as Texas Gas contained in Section 441(a) of the 1969 Tax Reform Act, had already been fully considered and resolved in prior cases in favor of liberalized depreciation with normalization.[20]

The other principal case relied upon by the petitioners here, *National Motor Freight Traffic Association* v. *United States*,[21] is likewise inapposite. In that case, the Interstate Commerce Commission, after Congress had vested reparations authority in the courts in cases involving motor carriers, had announced an informal process for restoring to

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[20] See *Northern Natural Gas Co.*, 25 FPC 431 (1961), in which the Commission found that the use of liberalized depreciation with normalization provided tax benefits not available under straight-line depreciation. These benefits were shared with the ratepayers if a less-than-normal or zero rate of return was allowed on the tax reserve or if it was completely deducted from the company's rate base (as here) [25 FPC at 439-441]. In addition, the Commission in the instant set of cases, in denying petitions for rehearing, stated:

> The use of straight-line depreciation eliminates the possibility of tax deferrals to natural gas pipeline companies. On the other hand, liberalized depreciation with normalization may generate substantial tax deferrals. *The benefits of these tax deferrals are shared*, although admittedly not necessarily in equal proportions, *by the company and its customers* by treating such amounts as rate base deductions. [44 FPC 16 (1970) (emphasis added)]

[21] 268 F. Supp. 90 (D.D.C., three judges, 1967), *aff'd* 393 U.S. 18 (1968).

shippers past charges which were currently agreed by the carrier to have been illegal. This procedure did not relate to any substantive power specifically granted the ICC and the court in that case held that a rulemaking process was required to ascertain whether such authority existed in the first place and, if so, whether it should be exercised. In such a situation, unlike that presented by the set of cases at hand, the creation of procedures was an integral part of a substantive determination that could not be made without notice and opportunity for hearing. Here, however, since the only option open to the FPC was a choice between leaving a utility electing to abandon flow-through with respect to its post-1969 expansion property under Section 441(a) of the 1969 Tax Reform Act on straight-line depreciation, and, permitting it to use liberalized depreciation with normalization, hence, there was no need for prior notice or a hearing. Prior decisions of the Commission had already resolved this issue in favor of liberalized depreciation with normalization.[22]

II.

The second set of cases—24,517 and 24,632—involves the validity of the FPC's decision in its Opinions No. 578 and 578-A and accompanying orders, permitting Texas Gas to change from liberalized depreciation with flow-through to such depreciation with normalization in regard to its pre-1970 and post-1969 *non*-expansion property.

Section 441(a) of the Tax Reform Act of 1969 amended the Internal Revenue Code of 1954 by adding subsection (1), "Reasonable allowance in case of property of certain utilities," to Section 167 of the IRC. Section 441(a) distinguishes between two types of utility property: (1) pre-1970 and post-1969 non-expansion property and (2) post-1969 expansion property. With respect to the latter type,

[22] See note 20, *supra*.

Section 441(a) permits utilities using liberalized depreciation with flow-through to elect within 180 days of the enactment of Section 441(a) to shift either to straight-line depreciation of their own volition or to liberalized depreciation with normalization with the permission of the appropriate regulatory agency. Texas Gas exercised this option with respect to its post-1969 expansion property and received the FPC's permission to employ liberalized depreciation with normalization—the validity of which is treated in I., above.

In the instant set of cases, the determination of whether the FPC was correct in permitting Texas Gas to shift from liberalized depreciation with flow-through to similar depreciation with normalization with respect to its pre-1970 and post-1969 non-expansion property requires, first, a review of Section 441(a) and its legislative history to ascertain the intent of Congress here and, second, a consideration of the validity of the Commission's decision in light of this Congressional intent.

A.

Section 167(a) of the Internal Revenue Code of 1954[28] provides that a taxpayer is entitled to a "reasonable allowance" for a tax depreciation deduction. Section 441(a) of the 1969 Tax Reform Act specifies the appropriate methods for computing this "reasonable allowance" for pre-1970 and post-1969 non-expansion property in the case of regulated utilities such as Texas Gas. Under Section 441(a), a "reasonable allowance" may be computed in either of two ways: one, a "subsection (1) method," refers to the straight-line method of depreciation, while the other is "the applicable 1968 method for such property," but "only if the taxpayer uses a normalization method of

[28] Int. Rev. Code of 1954, § 167(a), ch. 736, 68A Stat. 51, as amended Publ. L. 89-800, § 2, 80 Stat. 1513 (1966).

accounting."[34] Section 441(a), however, provides an exception to the normalization requirement for using the second method by allowing a utility using the flow-through method to continue doing so.[35]

The right conferred on regulated utilities such as Texas Gas by Section 441(a) of the 1969 Tax Reform Act to make an election within 180 days of the enactment of Section 441(a) to shift from liberalized depreciation with flow-through to either straight-line depreciation or, with the approval of the appropriate regulatory agency, liberalized depreciation with normalization with respect to their post-1969 expansion property, as discussed in I., *supra*, does not, however, apply to pre-1970 and post-1969 non-expansion property.

The legislative history accompanying the enactment of Section 441(a) clearly reveals the intent of Congress that the right of election provided utilities to shift from liberalized depreciation with flow-through either to straight-line or to liberalized depreciation with normalization be confined simply to post-1969 expansion property. While the progress of Section 441(a) through both houses of Congress and in conference reveals the existence of differences as to what types of property should be made eligible under the election provision, *the final version of the bill limits the applicability of the right of election to post-1969 expansion (non-replacement) property alone.*

At the first stage, the House Report indicated:

> Your committee's bill provides that, in the case of *existing* property, the following rules are to apply:
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> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

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[34] See note 1, *supra*, at § 167(1)(A).

[35] *Id.*, at § 167(1)(B).

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

(3) If the taxpayer is taking accelerated depreciation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.[28]

Thus, under the House version of the bill, Texas Gas, since it had been using accelerated depreciation with flow-through, would have been required to continue doing so with respect to its "existing" (including replacement) property unless the Commission permitted otherwise. If this had been the law enacted, the Commission's and Texas Gas' position here would have been clearly justified. But, as we shall see, the law actually passed was significantly changed.

The bill as reported by the Senate Finance Committee gave regulated utilities using liberalized depreciation with flow-through an election to abandon that method of depreciation both for "pre-1970" property (a change from "existing" property in the House version) and "post-1969" property ("other" property in the House bill). The Senate Report states in regard to the altered right of election:

> The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the regulatory agency, or permit it with the permission

[28] H.R. Rep. No. 413 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 132-33 (1969) (emphasis added).

of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill). This election applies both as to new and *existing* property."[7]

Under the Senate version of the bill, therefore, Texas Gas would have been permitted to shift from liberalized depreciation with flow-through either to straight-line depreciation or, with the FPC's approval, to liberalized depreciation with normalization.

However, in conference, it was agreed that this right of election would be restricted to apply to post-1969 *expansion property only.* The Conference Report states:

> 1. *Depreciation allowed regulated industries (sec. 167 of the code)*
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> The House bill provides that in the case of certain regulated industries (the furnishing or sale of . . . gas through a local distribution system, . . . and transportation of gas by pipeline) a taxpayer is *not permitted* to use accelerated depreciation *unless it "normalizes"* the current income tax reduction resulting from the use of such accelerated depreciation. . . .
>
> *This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account.* Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.
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> The Senate amendments make the following changes in the House bill: . . . (d) *an election is permitted to be made within 180 days after the date of enactment by a company at present on flowthrough to come under the rules of the bill;* . . .
>
> *The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) follows the Senate amendment except that the special provision referred to in*

[7] See note 6, *supra* (emphasis added).

(c) above is stricken and the 180-day election (item (d), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company."[*]

Thus, Texas Gas is unable to invoke the election provision of Section 441(a) to abandon liberalized depreciation with flow-through with respect to its "existing" (including replacement) property for two reasons: first, since Texas Gas has been employing liberalized depreciation with flow-through, it is specifically prohibited, under the final version of the bill, from abandoning such depreciation (see the second paragraph of the Conference Report, *supra*); and, second, since the right of election was restricted to apply to post-1969 expansion property *only*, Texas Gas may not seek to circumvent this restriction by applying it to its pre-1970 and post-1969 *non*-expansion property—the subject of this set of cases (24,517 and 24,632).

What the Commission does by its decision in this set of cases, then, is to produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969. This effect was considered by Congress in its deliberations on the appropriate scope for the right of election provided by Section 441(a), both in terms of its impact on rates and on tax revenues, and was specifically rejected. The Report of the House Committee on Ways and Means states:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competi-

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[*] See note 7, *supra* (emphasis added).

tive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.

Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries."[50]

The Senate Report agreed with this perspective, stating in relevant part:

> Accordingly, the committee agrees with the House that it is *appropriate to in general* [sic] *'freeze' the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more flourishing utility industries.[51]

The Senate Report, agreeing that a company using straight-line depreciation with normalization could not shift to flow-through under the bill, stated, with specific reference to utility companies such as Texas Gas which have been using liberalized depreciation with flow-through, "[o]ther companies—those that now flow through, as well as those in other regulated industries—are not limited by this general rule of the bill."[52]

Also, as the Summary of the Bill, prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, observes with respect to the impact of Section 441(a) on revenues as well as rates:

> The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since

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[50] See note 26, *supra* (emphasis added).

[51] See note 6, *supra* (emphasis added).

[52] *Id.*, at 174.

by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.[22]

There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow-through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property. According to Congress, the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid.[23]

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[22] Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, at 73.

[23] In a recent analogous case, the California Supreme Court held that Pacific Telephone and Telegraph Company's refusal, despite the fact that the California Public Utilities Commission was imputing accelerated depreciation with flow-through to those utilities which, like Pacific Telephone, used straight-line depreciation, to abandon straight-line depreciation (even though this meant a higher tax burden for Pacific Telephone in light of its expanding plant) [See pp. 4-5 of Slip Op.] was an "imprudent management decision" which it should not be permitted to pass on to its customers by means of higher rates. As the court there noted,

> . . . [I]t is clear that requiring ratepayers to put up the capital for the telephone system is contrary to the basic principle of utility rate setting. The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. . . . By permitting Pacific to include in its costs a charge for federal taxes greatly in excess of its actual federal tax ex-

B.

The FPC has argued that there is nothing in this Tax Reform Act indicating an intent on the part of Congress to alter the Commission's power to exercise its informed judgment as to what method of accounting can properly serve as the basis of ratemaking, and to weigh the cost to the consumer and the necessity to preserve a viable industry. The FPC urges that had Congress had such an intent, Congress would have manifested it by an amendment to the Natural Gas Act, not to a Revenue Act.

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pense, the Commission is deviating from this basic principle. We realize that the 1968 commission decision also deviated from the basic principle by refusing to permit Pacific to include in its costs all of its tax expense, but this deviation was based on Pacific's imprudent management.

It should also be pointed out that the effect of the instant decision [of the Commission below] is to reward Pacific for its imprudent management as compared to other utilities which prudently had adopted accelerated depreciation and flow-through prior to August 1969. Apparently, these utilities will continue to be required to flow-through the benefits of accelerated depreciation to the ratepayers, whereas Pacific will be allowed to use accelerated depreciation [under the Commission's decision below] without requiring flow-through, thus retaining most of the benefits for itself.

In the circumstances, we are satisfied that, in the light of Pacific's past imprudence, the commission could reasonably have ordered Pacific to continue the accounting practices established in the 1968 decision and that the commission abused its discretion in expressly *refusing to consider* imputed acceleration depreciation and flow-through as established in the 1968 decision.

City and County of San Francisco v. *Public Utilities Commission et al.*, S.F. 22794, & *Consumers Arise Now et al.* v. *Public Utilities Commission and Pacific Telephone and Telegraph Company*, S.F. 22793, pp. 15-16, Slip Op. (emphasis in original).

This overlooks the undeniable fact that methods of calculating depreciation are relevant both for taxation and ratemaking purposes. Congress here dealt with depreciation in the context of a revenue measure, but all its deliberations—particularly the committee reports of both houses, the conference committee report, and most significantly, the changes made in the bill at different stages—show its keen awareness of the measure's impact on the federal revenue, the natural gas industry, and the consumers. It may well be that some of the FPC's regulatory discretion has been lost by the enactment of this law; in effect, Congress has pondered the question, and has exercised what formerly was the FPC's perogative for it. The fact that Congress did so in the context of a Tax Reform Act cannot vitiate what Congress enacted.

To hold otherwise would be to rule that the carefully considered changes, granting an election to the company with respect to its expansion property but eliminating any choice by either company or FPC with respect to the company's *non-expansion property*,[24] were meaningless. The rule here urged by the FPC and Texas Gas is similar to that policy proposed by Chairman White, and this was rejected.[25] We here give effect to what Congress did; albeit cloaked in a revenue act, a statutory mandate in regard to the calculation of depreciation has an effect on the FPC's power to exercise its independent judgment as to what best will serve industry and consumers.

Our holding, however, should not be taken to mean that Section 441(a) of the Tax Reform Act of 1969 deprives the Commission in all cases of its discretion under the Natural Gas Act to permit utilities to abandon flow-through. There might be extraordinary circumstances in

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[24] See notes 3 and 23, *supra*.

[25] See note 26, *supra*.

which Section 441(a), taken in conjunction with the mandate of the Natural Gas Act, should not be construed to prevent the FPC in its underlying responsibility of protecting consumer interests from finding that those interests would be furthered by permitting the abandonment of flow-through. It is clear, however, that such consumer interests would not be furthered by permitting Texas Gas to abandon flow-through in the circumstances presented by the case at bar.

III.

Accordingly, the decision of the Federal Power Commission in its Orders No. 404 and 404-A with respect to the post-1969 *expansion* property of Texas Gas—the subject of cases no. 24,518 and 24,602—is affirmed. However, the action of the Commission in its Opinions No. 578 and 578-A and accompanying orders in regard to Texas Gas' pre-1970 and post-1969 *non*-expansion property—the subject of cases no. 24,517 and 24,632—is vacated and remanded to the Commission for action in accordance with this opinion.

SO ORDERED.

APPENDIX B

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 24,517

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION
TENNESSEE VALLEY MUNICIPAL GAS ASSOC., ETC.,
INTERVENORS

No. 24,632

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

On Petitions for Rehearing

Filed May 11, 1972

Before FAHY, *Senior Circuit Judge*, and ROBINSON and WILKEY, *Circuit Judges*.

WILKEY, *Circuit Judge*: Petitions of the Federal Power Commission and Texas Gas Transmission Corporation, an intervenor, for rehearing and suggestions for rehearing *en banc*, of this court's action in vacating the order of the Commission with respect to Texas Gas' pre-1970 and post-1969 *non*-expansion property, focus on three main points:

1. Whether Congress' enactment of the 1969 Tax Reform Act limited the extent of the Commission's authority to permit regulated utilities such as Texas Gas to shift from accelerated depreciation with flow-through to similar depreciation with normalization with respect to their pre-1970 and post-1969 non-expansion property.

2. The import of the explanation of Section 441(a) of the 1969 Tax Reform Act in regard to point 1, *supra*, provided by the Staff of the Joint Committee on Internal Revenue Taxation.

3. The court's caveat, at the end of its opinion, with respect to the effect of Section 441(a) of the Act on the Commission's discretion to permit regulated utilities such as Texas Gas to abandon flow-through.

We deny the petitions for rehearing, as we find the Commission's and Texas Gas' arguments unpersuasive. Since both manifest some confusion over the meaning of our opinion and what we deem the proper interpretation of the statute involved, we set forth these additional views on the specific points raised in an effort at clarification for the responsible regulatory agency and the industry involved.

I. *The Extent of the Commission's Authority under Section 441(a) of the 1969 Tax Reform Act re Non-Expansion Property*

The Commission and Texas Gas return to the initial

House version of Section 441(a) of the 1969 Tax Reform Act to support their contention that Section 441(a), as finally enacted, did not curtail the Commission's discretion, with respect to pre-1970 and post-1969 *non*-expansion (existing or replacement) property, to permit regulated utilities such as Texas Gas to shift from accelerated depreciation with flow-through to similar depreciation with normalization. They point out (we do not disagree, see first full paragraph of text, page 16 of Slip Op.) that the House version would have permitted Texas Gas, with the Commission's approval, to shift from flow-through to normalization with respect to its pre-1970 and post-1969 non-expansion (as well as its post-1969 expansion) property.

It is at the Senate stage of the proceedings that our views diverge. Texas Gas and the Commission argue that the FPC's discretion to permit a regulated utility such as Texas Gas to shift its depreciation treatment of *non*-expansion property survived through both the Senate and Conference Committee versions of the legislation. Their interpretation is that subsequent versions reflect *additional* provisions (*e.g.*, the 180-day period during which the company may elect to change its method of depreciation) rather than *substitute* provisions which eventually made up the final bill. We think our analysis (pp. 15-18, Slip Op.) of the changes at different stages of the legislation makes clear why this contention is not valid, but for greater clarity we shall chart the transformations as the Tax Reform Act progressed through the legislative stages (see page 4).

Thus, between the initial House and Senate versions of Section 441(a), two differences emerge with respect to Situation III and to shifting from flow-through: First, under the Senate version, in contrast to the House, FPC approval is *not* required to shift from the flow-through to the straight-line method; and, second, the Senate limited (the Commission and Texas Gas can point to no

House Version Bookkeeps These Possible Present Situations re both expansion and non-expansion Property Depreciation	*House Version Proposes These Permissible Changes, with No Time Limit re Changes*	*Senate Version Bookkeeps Same Three Present Situations, but (1) Created Under III A Difference Is Agency Approval Required; and (2) Limited Either Change to a 180-Day Election Period*	*Conference Committee Version*
I. Straight-line	None allowed	(Same)	(Same)
II. Normalization	To straight-line, or continue normalization, *without* agency approval (could not change to flow-through)	(Same)	(Same)
III. Flow-through	Continue flow-through, unless change to Straight-line, *with* agency approval; or Normalization, *with* agency approval	Continue flow-through, unless change to A. Straight-line, *without* agency approval; or B. Normalization, *but only with* agency approval. Either change to be elected within 180 days.	Same as Senate, but *modified* to make the 180-day election (item (3) in Conf. Rep.) apply to only (post-1969) property only, and available only to extent public utility capacity increased.

* For legislative history supporting this analysis, see: H.R. Rep. No. 413 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 131-134 (1969); S. Rep. No. 552 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 171-176 (1969); Conf. Rep. No. 782, 91st. Cong., 1st Sess. 312-313 (1969).

language to the contrary) *all* changes re both expansion and non-expansion property to a 180-day election period. In view of these differences, the Conference Committee was free to modify the House and Senate versions in an attempt to resolve them.[1] Neither Texas Gas nor the Commission dispute the power of the conferees to make the second change, to curtail the 180-day election provision so as to apply *only* to post-1969 expansion property.

As to the first change, there was clearly a disagreement between the Senate and the House over the right of a regulated utility to shift from accelerated depreciation with flow-through to straight-line depreciation, with or without agency approval. This disagreement entitled the conferees (1) to choose the Senate version, limiting all shifting from the flow-through method to a 180-day period, *and (2) to make it applicable to post-1969 expansion property only.* Clearly, such an option is a "germane modification of subjects in disagreement"—here the permissible extent of abandonment of accelerated depreciation with flow-through.

The variety and extent of differences between the two versions was acknowledged by the Staff of the Joint Committee on Internal Revenue Taxation,[2] a source much

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[1] Section 136 of the Legislative Reorganization Act of 1946, 2 U.S.C. § 190(c)(a), provides in pertinent part:

> (a) In any case in which a disagreement to an amendment in the nature of a substitute has been referred to conferees, it shall be in order for the conferees to report a substitute on the same subject matter; but they may not include in the report matter not committed to them by either House. *They may, however, include in their report in any such case matter which is a germane modification of subjects in disagreement* (emphasis supplied).

[2] As stated in the Letter of Transmittal in their *General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172* (3 December 1970).

relied upon here by the Commission and Texas Gas: "The Tax Reform Act of 1969, because of its comprehensive scope and because of the *many changes* which were made in this legislation, both by the Senate and *subsequently by the conferees*, is an illustration where the differences [between the versions of each House] were especially significant."[3]

In permitting a taxpayer such as Texas Gas to shift from accelerated depreciation with flow-through to straight-line depreciation with or without the appropriate agency's approval, the Senate was no doubt interested in increasing governmental revenues (since under flow-through the tax reduction is passed on to the utility's customers). The House, however, by limiting changes from flow-through either to straight-line or normalization *only with* agency approval, was reflecting the concern that emphasis on a shift to straight-line depreciation, as expressed by the Senate version, would place taxpayers such as Texas Gas at a competitive disadvantage, both as to the sale of their products or services and as to their attractiveness to equity investors.[4]

Thus, the conferees' resolution of this disagreement in favor of the latter concern by limiting the extent to which regulated utilities may abandon flow-through reflects Congress' overall intent "in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries."[5] And, as both the House and

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[3] At p. 111 (emphasis added).

[4] H.R. Rep. No. 413 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 132 (1969).

[5] *Id.*, at 133; *see also*, to the same overall effect, S. Rep. No. 552 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 172 (1969), which states: "Accordingly, the committee agrees with the House that it is appropriate to in general [sic]

Senate Reports indicate, "About half the regulatory agencies require utilities that use accelerated depreciation for tax purposes to 'flow through' the resulting reduction in Federal income taxes currently to the utilities' customers. . . . Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes; even if those utilities use straight line depreciation for tax purposes, such agencies treat them for ratemaking purposes as though they had reduced their Federal income tax expense by using accelerated depreciation."[6]

This overall congressional objective to forestall prospective revenue losses, without handicapping the utility industry, was a prime consideration at all stages of the legislation. In focusing on the specific language of the House version of the bill, Texas Gas and the Commission give no notice to this overall objective, the weight it had at all stages, and how the final conferees' changes reflect this, although we stressed this in our opinion (pp. 18-20, Slip Op.).

II. *Import of the General Explanation by the Staff of the Joint Committee on Internal Revenue Taxation.*

Reliance by the Commission and Texas Gas on one specifically cited portion of the *General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172*, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (3 December 1970), for support for the proposition that Section 441(a) of the Act as finally enacted did not diminish the Commission's authority to permit a taxpayer such as Texas Gas from abandoning flow-through with respect to its

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'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries."

[6] H.R. Rep. No. 413, at 131-132; S. Rep. No. 552, at 171-172.

pre-1970 and post-1969 non-expansion property is mistaken. We are cited to page 151 of the *General Explanation*, to wit:

> More specifically, in the case of *existing* property the following rules apply:
>
> * * * *
>
> (3) If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so *(except for a special election procedure discussed below)*, unless the appropriate regulatory agency permits a change as to that property. *That is, the Act does not require the taxpayer to flow through, but it also does not affect any power the regulatory agency might have to require the taxpayer to flow through.* (Emphasis supplied.)

The first revealing aspect of this language is that all of it except the italicized portions (which were added by the Staff) was lifted, with only minor modifications, from the House and Senate Reports,[1] both of which were com-

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[1] The House Report describes the House Bill:

> (3) If the taxpayer is taking accelerated depreciation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.

H.R. Rep. No. 413 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 123 (1969).

The Senate Report in turn describes the House Bill:

> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property.

S. Rep. No. 552 [To Accompany H.R. 13270], 91st Cong., 1st Sess. 178 (1969).

meeting on the initial House version of Section 441(a). For the Commission and Texas Gas, then, to point to this language as determinative of Congress' *final* intent in enacting Section 441(a) of the Act is unavailing. At best, this language is confusing and uncertain; it cannot carry the meaning ascribed to it by the Commission and Texas Gas, particularly in view of the following page 152, discussed *supra*. Significantly, there is no mention of such continued Commission authority in this particular respect in the Conference Committee Report, an omission reflecting the conferees' resolution of the differences between the two initial versions of Section 441(a).

Furthermore, as we have seen by the provisions discussed and displayed in the chart, *supra*, there never was at any time in any version of the House, Senate, or conference, a power in the agency to compel or permit a company to change from any method of depreciation accounting to flow-through. To have included such a provision would have been directly contrary to the overall objective of this portion of the Act—"in general to 'freeze' the current situation regarding methods of depreciation." (As discussed pp. 18-20, Slip Op.) After the Tax Reform Act of 1969, the permissible shifts were contemplated to be *away from* flow-through, at the company's option, with changed requirements as to agency approval and time (see chart, *supra*).

Finally, the comfort Texas Gas and the Commission derive from page 151 is taken away by page 152 of the *General Explanation*, not cited to us. There we find:

> The Act permits an election to be made within 180 days after the date of enactment of the Act—i.e., by June 28, 1970—for a utility in one of the regulated industries covered by this provision to shift from the flow-through to the straight line method, with or without the permission of the appropriate regulatory agency, or to permit it with the permission of the regulatory

agency to shift to the normalization method, that is, to come under general rules of the Act.

This election applies to new property, but only to the extent it increases the taxpayer's capacity . . ."[1]

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[1] Staff of the Joint Committee on Internal Revenue Taxation, *General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172*, 182 (2 December 1970). The language of the statute, as it is codified, reflects the fact that a utility's election to shift from flow-through to a different method of depreciation is applicable only to new expansion property:

(1) Reasonable allowance in case of property of certain utilities.—

(1) *Pre-1970 public utility property.*

(2) *Post-1969 public utility property.*—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (1) method,

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1969 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(4) *Special rules as to flow-through method.—*

(A) *Election as to new property representing growth in capacity.*—If the taxpayer makes an election under this subparagraph within 180 days after the date of the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2) (C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer

Here we have set forth the rule—and the rationale therefor—of the final version of the statute. "Utilities on flow-through could elect" to change to either straight-line depreciation or accelerated depreciation with normalization within 180 days after enactment of the Act, but—"This election applies to new property, but only to the extent it increases the taxpayer's capacity."

There is nothing about old, existing, non-expansion property which "increases the taxpayer's capacity." Only new, expansion property could do so. Hence, if we bear in mind the congressional intent generally "to freeze" the present depreciation situation, it appears logical that the permissible shift in accounting practices would be limited, and that an exception might logically be made for new expansion property increasing productive capacity, at taxpayer option, and with agency approval required if the shift is to normalization. If we take Texas Gas' and the Commission's evaluation of the words on page 151—and ignore page 152 completely—then the exception is for all property and swallows up the whole, thus vitiating any congressional intent "to freeze" generally depreciation accounting practices for utilities. Texas Gas and the FPC continually urge that there are no words in this Tax Reform Act saying specifically that the Power Commission's discretion is curtailed, an argument which, to our minds, simply misses the purpose of this portion of the Act. The objectives in regard to a general freeze, in regard to balancing pro-

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with respect to the goods or services described in paragraph (8)(A) and does not represent the replacement of existing capacity.

Int. Rev. Code of 1954, § 167(1), *as amended* 1969.

While some may see differently, we suggest that the intent of Congress is not readily apparent on the plain face of this statute; hence our resort to its legislative history.

spective revenue loss against possible impairment of the utilities' ability to raise capital and service customers at low rates, all would have been difficult to achieve without placing the resulting limitation on the Commission's discretion. This the language of the Tax Reform Act necessarily did, and to hold otherwise would be to undo what was most carefully done.

III. *The Court's Caveat with Respect to the Effect of Section 441(a)*

Finally, the Commission asserts that the court's opinion is misleading in that "On the one hand, this Court finds that the Commission lost its discretion to allow Texas Gas to switch from flow-through. Yet this Court holds that the Commission has discretion to permit abandonment of flow-through in 'extraordinary circumstances.'" (Commission brief, p. 13, n. 6.)

The Commission fails to read the court's language with care. What we stated is that "There *might be* extraordinary circumstances in which Section 441(a), taken in conjunction with the mandate of the Natural Gas Act, should not be construed to prevent the FPC in its underlying responsibility to protecting consumer interests from finding that those interests would be furthered by permitting the abandonment of flow-through." [Slip Op., pp. 22-23 (emphasis supplied).] Clearly, the court's language indicates simply the possibility that such circumstances might exist; it does not state that they do. For the Commission to assume otherwise is to ignore the plain meaning of the court's language. What the court intended here was merely to leave open the possibility that such circumstances might exist, rather than to assume categorically that they do not.

IV. *Conclusion*

For the reasons stated above, the petitions of the Commission and Texas Gas for rehearing are

Denied.

APPENDIX C

United States Court of Appeals for the District of Columbia Circuit

September Term, 1971

No. 24,517

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION, ETC., INTERVENORS

No. 24,632

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

TEXAS GAS TRANSMISSION CORPORATION, INTERVENOR

Petitions for Review of Orders of the Federal Power Commission

Before: FAHY, *Senior Circuit Judge*, and ROBINSON and WILKEY, *Circuit Judges*.

JUDGMENT

These cases came on to be heard on the record from the Federal Power Commission, and were argued by Counsel. Upon consideration thereof, it is

ORDERED AND ADJUDGED by this Court that orders of the Federal Power Commission on review herein are hereby vacated, and these cases are hereby remanded to the Federal Power Commission for action in accordance with the opinion of this Court filed herein this date.

A true copy:

NATHAN J. PAULSON,
Clerk.

DOROTHY E. LONG,
Deputy Clerk.

Dated: February 18, 1972.

Opinion by Circuit Judge Wilkey.

APPENDIX D

United States of America, Federal Power Commission

ACCOUNT 282; LIBERALIZED DEPRECIATION; FLOW-THROUGH; ACCUMULATED DEFERRED TAXES; NORMALIZATION

Before Commissioners: JOHN N. NASSIKAS, *Chairman*; LAWRENCE J. O'CONNOR, JR., CARL E. BAGGE, JOHN A. CARVER, JR., and ALBERT B. BROOKE, JR.

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Opinion No. 578

OPINION AND ORDER GRANTING PERMISSION TO USE LIBERALIZED DEPRECIATION WITH NORMALIZATION FOR ACCOUNTING AND RATE PURPOSES

(Issued June 3, 1970)

NASSIKAS, *Chairman*:

1. The rate and accounting issues with respect to the property of Texas Gas Transmission Corporation on which liberalized depreciation is now being taken with flow-through of benefits are now before the Commission while other issues in this proceeding are subject to settlement negotiations. The proceedings commenced with the filing of a rate increase by Texas Gas on June 27, 1969, in Docket No. RP69-41, which

was suspended until January 12, 1970; a further rate increase was filed on November 7, 1969, in Docket No. RP70-14 to track a rate increase filed by its supplier, United Gas Pipeline Company, and this was suspended until May 16, 1970.

2. At the hearing the proceeding was divided into two phases by the Presiding Examiner with Phase I comprising questions of rate of return, associated income taxes, and reversion to straight-line depreciation. On motion of Staff Counsel the Commission omitted the intermediate decision with respect to Phase I issues, and briefs were filed by a number of parties. Lately settlement negotiations have been held among the parties and the Commission Staff with respect to both Phase I and Phase II issues, but the issues relating to liberalized depreciation have been left for determination by the Commission. On May 4, 1970, Texas Gas filed a motion for an expedited decision on the tax depreciation issue alleging that under the Tax Reform Act of 1969, 83 Stat. 487, it would have to make an election with respect to certain "post-1969" property on or before June 29, 1970, and requesting oral argument. An answer to the motion was filed by the City of Hamilton, Ohio, contesting some of Texas Gas' arguments, agreeing that the case should be resolved without any further delay, and also asking for oral argument.

3. Texas Gas now employs liberalized depreciation under Section 167 of the Internal Revenue Code and flows through the benefits to its customers. It alleges that it did not make an election to utilize liberalized depreciation until the Commission had issued a declaratory order that it would permit companies subject to its jurisdiction to normalize taxes for both accounting and ratemaking purposes. *Amere Gas Utilities Co.*, 15 FPC 760 (1956). Under this normalization tech-

sique, Texas Gas computed its tax allowance for rate-making purposes as though it were using straight-line depreciation, but used liberalized depreciation for computing the amount of taxes actually paid. The difference between taxes collected through its rates and taxes actually paid was credited to Account 282, Accumulated Deferred Income Taxes—Liberalized Depreciation.

4. In *Alabama-Tennessee Natural Gas Company*, 31 FPC 308, 923 (1964), aff'd 359 F. 2d 318 (5th Cir. 1966), cert. *denied* 385 U.S. 847 (1966), we required that the tax benefits of liberalized depreciation be flowed-through to consumers. Texas Gas, for the reasons discussed below, now proposes to abandon flow-through for accounting and ratemaking purposes. For post-1969 property representing an expansion it proposes to effect this by an election under the Tax Reform Act and has shown a preference to utilize liberalized depreciation with normalization. For pre-1970 property, and presumably any other property not subject to the election, it now states by letter dated May 22, 1970, served on all the parties that:

> This letter is being written in order to make it perfectly clear that Texas Gas proposes to use a normalized method of accounting with respect to pre-1970 public utility property if the Commission permits Texas Gas to use normalization for rate-making purposes. Alternatively, Texas Gas proposes to revert to a straight-line method of computing tax depreciation with respect to pre-1970 public utility property, if the Commission permits the associated taxes to be included in Texas Gas' cost of service. Of the two methods, Texas Gas prefers the normalization method.

5. The Tax Reform Act (Section 441 amending Section 167 of the Internal Revenue Code) divides

utility property into pre-1970 property (that which was utility property in the hands of any person at any time before January 1, 1970) and post-1969 property (that which is not pre-1970 property). A taxpayer, like Texas Gas, using the flow-through method of accounting may with respect to post-1969 property elect to change to straight-line depreciation, or with our permission to the normalization method, to the extent the property increases the productive or operational capacity of the taxpayer and does not represent the replacement of existing capacity. Contrary to some of the arguments expressed in the briefs, it is clear that Congress intended this election to apply for rate making purposes as well as tax purposes.

6. The Senate Report[1] states that where the election is made "the agency would not be able to impute the use of accelerated depreciation with flow-through"; and the House Report[2] states "the taxpayer will be permitted to elect straight line depreciation as to such new property and, if the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted to in effect force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes." It is true, as the City of Hamilton points out, that the House Committee rejected the suggestion that utilities be required to revert to straight line depreciation and stated that it intended to "freeze" the current situation regarding methods of depreciation in order to avoid putting the companies at a competitive disadvantage or inducing widespread rate increases, but this was the general policy and a specific exception was made for an elec-

[1] Senate Report No. 91-552 on H.R. 13270, pp. 173-174.
[2] House Report No. 91-413 on H.R. 13270, p. 133.

...with respect to post-1969 property where the companies wished to depart from the flow-through method.

7. Referring to these provisions of the Tax Reform Act in our Order No. 404, Statement of Policy, issued May 15, 1970, we determined that it was in the public interest, as to property as to which the election is made, "that electric and natural gas pipeline companies regulated by the Commission be permitted to employ a normalization method in their accounts and annual reports, as well as for ratemaking purposes," but we did not decide the ratemaking or accounting issues with respect to other property such as that constructed or acquired prior to January 1, 1970, on which flow-through is being used. Therefore in this proceeding if Texas Gas elects to abandon flow-through on post-1969 property, it is permitted to employ normalization for accounting and ratemaking purposes, but there still must be determined the question whether it may abandon flow-through and use liberalized depreciation with normalization for property not subject to the election, that is the pre-1970 property and the post-1969 property which does not represent an expansion. Under the Tax Reform Act our authority to determine whether a company may elect such a change is not diminished.[1]

8. In our opinion Texas Gas has shown good reason to abandon flow-through for accounting and ratemaking purposes. In *Alabama-Tennessee*, we based our conclusions on our finding that liberalized depreciation would exceed straight-line depreciation where the company continues to make capital additions. Even where the composite plant of a company remains stable, we found, annual liberalized depreciation would

[1] House Report No. 91-413, U.S. Code Congressional and Administrative News, p. A-141.

not be lower than straight line depreciation. Thus we concluded that a regulated utility would never be required to pay higher income taxes because of its election to obtain liberalized depreciation unless its gross plant declines in dollar value as a result of lower demand or lower plant construction costs. In support of this approach we noted that almost all responsible forecasts reflected the widespread belief that the gas pipeline industry would continue to expand at least until 1980, and we concluded that the pattern of growth in demand and plant capacity with respect to Alabama-Tennessee and the gas pipeline industry generally would continue for the reasonably foreseeable future. We followed the same approach in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1961), aff'd 298 F. 2d 444 (7th Cir.), *cert. denied*, 369 U.S. 808 (1962). It should be observed that while we were upheld in requiring flow-through in both these cases, the court in neither case indicated that we are required to order that the companies use flow-through.

11 Under the present circumstances the considerations applicable in *Alabama-Tennessee* and *Midwestern* do not obtain. By reason of Texas Gas' proposed election under the Tax Reform Act and Order No. 404, depreciation on the facilities, constructed after the beginning of 1970 which increase its capacity, will be subject to normalization rather than flow-through. Therefore tax depreciation on such new facilities will not be available to offset the declining tax depreciation deductions on the older facilities as contemplated in the *Alabama-Tennessee* and *Midwestern* cases.

12 Excluding new expansion facilities from consideration, the continued use of liberalized depreciation on the pre-1970 plant will not create a tax saving. It is not an answer to urge that the allowable

tax depreciation of the pipeline plant remaining after addition of the post-1969 expansion facilities will be sufficiently stable to avoid forever repayment of taxes earlier avoided by liberalized depreciation. This is because the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties. In other words, the period of time over which the properties would be useful and depreciable for tax purposes is dependent on the gas supply rather than the useful physical life of the plant. It therefore follows that the pre-1970 tax plant will not be a stable plant in the sense that plant retirements are replaced by new facilities, but the basis of tax depreciation related thereto will decline, so that there is little chance with respect to this plant that there will be any permanent tax savings. Under these circumstances, therefore, Texas Gas is correct in contending that normalization in computing the tax allowance for rate purposes with respect to its pre-1970 facilities offers more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases. Further benefits of normalization are that it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and that it will help alleviate present heavy cash shortages.

11. While, of course, Texas Gas is subject to regulation and is required to operate with all reasonable economies,' here it would appear that a reversion to normalization with respect to the pre-1970 properties (and post-1969 properties not subject to the election) would lead to more stable tax costs in the long run insofar as its customers are concerned. It is likely that

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[illegible] *El Paso Natural Gas Co. v. F.P.C.*, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961).

not be lower than straight-line depreciation. Thus we concluded that a regulated utility would never be required to pay higher income taxes because of its election to claim liberalized depreciation unless its gross plant declines in dollar value as a result of lower demand or lower plant construction costs. In support of this approach we noted that almost all responsible forecasts reflected the widespread belief that the gas pipeline industry would continue to expand at least until 1980, and we concluded that the pattern of growth in demand and plant capacity with respect to Alabama-Tennessee and the gas pipeline industry generally would continue for the reasonably foreseeable future. We followed the same approach in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1961), aff'd 388 F. 2d 444 (7th Cir.), *cert. denied*, 392 U.S. 923 (1968). It should be observed that while we were upheld in requiring flow-through in both these cases, the court in neither case indicated that we are required to order that the companies use flow-through.

9. Under the present circumstances the considerations applicable in *Alabama-Tennessee* and *Midwestern* do not obtain. By reason of Texas Gas' proposed election under the Tax Reform Act and Order No. 484, depreciation on its facilities, constructed after the beginning of 1970 which increase its capacity, will be subject to normalization rather than flow-through. Therefore tax depreciation on such new facilities will not be available to offset the declining tax depreciation deductions on the older facilities as contemplated in the *Alabama-Tennessee* and *Midwestern* cases.

10. Excluding new expansion facilities from consideration, the continued use of liberalized depreciation on the pre-1970 plant will not create a tax saving. It is not an answer to urge that the allowable

tax depreciation of the pipeline plant remaining after retirement of the post-1969 expansion facilities will be sufficiently stable to avoid forever repayment of taxes earlier avoided by liberalized depreciation. This is because the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties. In other words, the period of time over which the properties would be useful and depreciable for tax purposes is dependent on the gas supply rather than the useful physical life of the plant. It therefore follows that the pre-1970 tax plant will not be a stable plant in the sense that plant retirements are replaced by new facilities, but the basis of tax depreciation related thereto will decline, so that there is little chance with respect to this plant that there will be any permanent tax savings. Under these circumstances, therefore, Texas Gas is correct in contending that normalization in computing the tax allowance for rate purposes with respect to its pre-1970 facilities offers more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases. Further benefits of normalization are that it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and that it will help alleviate present day cash shortages.

11. While, of course, Texas Gas is subject to regulation and is required to operate with all reasonable economies,[4] here it would appear that a reversion to normalization with respect to the pre-1970 properties (and post-1969 properties not subject to the election) would lead to more stable tax costs in the long run as far as its customers are concerned. It is likely that

[4] *See El Paso Natural Gas Co. v. F.P.C.*, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961).

tax costs under the flow-through method, while lower at this time than they would be under normalization, could increase in the future, putting financial pressure on the company and creating the need for increased rates. Under these conditions, the company's management is in the best position to examine and pass judgment on these effects, and we are prepared to respect the exercise of managerial discretion at least to the extent of permitting Texas Gas to adopt liberalized depreciation with normalization. Furthermore, upon re-examination of the basis of our *Alabama-Tennessee* and *Midwestern* decisions in the light of the Tax Reform Act of 1969, particularly its effect on post-1969 property, and the impact of the tax law on pipeline property, the findings made in those two cases are no longer applicable, and accordingly the cases are overruled to the extent they are inconsistent with this decision.

12. In reply to the arguments and evidence of Texas Gas on the effect of continuing liberalized depreciation and flow-through, Memphis presents an exhibit which purports to show that even if gross plant leveled off and then declined the use of liberalized depreciation would not require a rate increase, because the decline in return and related income tax would more than counterbalance any increase in tax resulting from lower deductions under liberalized depreciation. With comparable result, the Staff assumes an initial investment with no additions or retirements and shows that in the early years that the property is in service, as tax deductions decline, the advantage to consumers of using liberalized depreciation with flow-through declines until it becomes negative, but this tendency is offset by a tax reduction due to the decline in the rate base. In our opinion, the effect of the declining rate base should not be used to offset the

effects of liberalized depreciation with flow-through. Where there is no new investment the rate base declines in any case, regardless of the method of tax depreciation. While Texas Gas' pre-1970 properties may represent a declining net investment, the company will undoubtedly be adding to its entire rate base by post-1969 construction, and its operating expenses may well be increasing. Therefore, if Texas Gas remains on flow-through it appears that it may be benefitting present consumers at the unwarranted expense of future consumers. On the other hand, there appears to be little possibility that if Texas Gas chooses to use normalization on its pre-1970 property it will be providing for decreased rates to consumers in later years at the expense of present consumers.

13. To conclude, we shall grant approval to Texas Gas to exercise its discretion to abandon flow-through with respect to the pre-1970 property and post-1969 non-expansion property and to adopt liberalized depreciation with normalization with respect to this property. Texas Gas, through its election under the Tax Reform Act, already has permission to use liberalized depreciation with normalization with respect to its post-1969 expansion property. Balances in Account 282 should continue to be deducted from the rate base in computing cost of service for ratemaking purposes.

14. Because the issues have been well covered in the briefs we do not think that oral argument is necessary.

The Commission orders:

(A) In the computation of its Federal Income Tax allowance for ratemaking purposes as well as for accounting purposes, Texas Gas is permitted to use liberalized depreciation with normalization with respect to its property other than that subject to election under Section 167(1)(4)(A) of the Internal Revenue Code as amended by Section 441 of the Tax

Reform Act of 1969. Such election applies to property constructed or acquired on or after January 1, 1970, to the extent it increases the productive or operational capacity of the company and does not represent the replacement of existing capacity. Texas Gas may reflect any such change in its rates, as well as any change in costs arising from its proposed election. In computing its cost of service for ratemaking purposes balances in Account 282 should continue to be deducted from the rate base.

(B) Oral argument is denied.

By the Commission:

[SEAL] GORDON M. GRANT,
Secretary.

APPENDIX E

United States of America, Federal Power Commission

ACCOUNT 282; LIBERALIZATION DEPRECIATION; FLOW-THROUGH; ACCUMULATED DEFERRED TAXES; NORMALIZATION; PRACTICE AND PROCEDURE (DUE PROCESS)

Before Commissioners: JOHN N. NASSIKAS, *Chairman*; LAWRENCE J. O'CONNOR, Jr., CARL E. BAGGE, JOHN A. CARVER, Jr., and ALBERT B. BROOKE, Jr.

Docket Nos. RP69-41, RP70-14

TEXAS GAS TRANSMISSION CORPORATION

Opinion No. 578-A

OPINION AND ORDER DENYING REHEARING

(Issued July 21, 1970)

NASSIKAS, *Chairman*:

1. The Memphis Light, Gas & Water Division (Memphis) on June 29, 1970, the Public Service Commission of the State of New York (New York) on July 2, 1970, and the Philadelphia Gas Works Division of UGI Corporation (PGW) on July 6, 1970,[1] have filed applications for rehearing with respect to our Opinion No. 578 and order issued June 3, 1970, in the above-entitled proceeding. In Opinion No. 578 and order we permitted Texas Gas Transmission Corporation to use liberalized depreciation with normalization

[1] July 3, 4, and 5, 1970, were United States Government holidays.

with respect to property other than its post-1969 property, which is subject to election under Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, to abandon use of liberalized depreciation for tax purposes. Under our Order No. 404, Statement of Policy, issued May 15, 1970, instead of reverting to straight-line depreciation the electric or natural gas pipeline company making the election is permitted to employ the normalization method for accounting as well as ratemaking. In most cases the points made on rehearing have been considered in Opinion No. 578, and any further discussion would be superfluous, but in other cases additional comments, in our opinion, would indicate more clearly the basis of our opinion.

2. Memphis and New York contend that we deprived them of due process of law in permitting Texas Gas to adopt liberalized depreciation with normalization for the non-elective properties. New York says the sole depreciation issue was whether Texas Gas should be granted permission to abandon liberalized depreciation with flow-through in order to change to straight-line depreciation for tax purposes. The Presiding Examiner provided that the hearing should be phased in accordance with our order of August 11, 1969, 42 FPC 511. He stated that "In Phase I the issues of rate of return and related income tax will be tried, and the issue of the return from accelerated to straight-line depreciation, insofar as the principle thereof is involved" (Tr. 69-70). The Tax Reform Act and our Order No. 404 dealt with the property subject to election. With respect to the property not subject to election it seems clear that, if properly supported by the record, we could deny Texas Gas' request to depart from liberalized depreciation, or we could grant it. We could also prescribe other solutions to the problem. In this instance the use by Texas

of liberalized depreciation with normalization, while it increases the tax costs to its customers, has some advantages over a reversion to straight-line depreciation for tax purposes. Normalization, as our opinion indicates, would improve the company's cash position, would, in effect, provide it with an interest free fund, and, because of the deduction of the accumulated reserves in Account 282 from the rate base, would reduce the company's cost of service and benefit consumers. This is a solution which we find more in the public interest than reversion to straight-line depreciation, and we could have treated Texas Gas for ratemaking purposes as though it were following this course. Compare *Midwestern Gas Transmission Co.*, 25 FPC 61 (1961), aff'd 388 F.2d 444 (7th Cir.), *cert. denied* 392 U.S. 928 (1968). Therefore the letter from counsel for Texas Gas dated May 22, 1970, which we quote in our original opinion, does not change the nature of the proceedings or introduce a new issue. It merely shows that the company does not oppose the solution which we find preferable.

3. New York argues that there are relationships between the tax depreciation issue and the rate of return allowance, so that the Commission was not free to decide one of the issues without deciding the other. As explained in Opinion No. 578 the rate of return issue was subject to settlement negotiations which have now resulted in a settlement approved by the Commission. In that order it is pointed out that use of liberalized depreciation with normalization does not represent additional return to Texas Gas.

4. Memphis and New York also argue that we improperly founded our determination on management discretion. This was not our purpose. Because of the discretion authorized by the Tax Reform Act it is our opinion, as expressed in Opinion No. 578, that tax

costs under the flow-through method could increase in the future with undesirable rate consequences. While our findings and conclusions were supported by the judgment of management, we were not basing them on management discretion but on our own judgment of the facts and the law.

5. They argue, further, that the Tax Reform Act or its legislative history do not permit or require us to allow the use of liberalized depreciation with normalization. Section 441 of the Tax Reform Act, it is true, does not require a change from flow-through to normalization, but providing an election with respect to post-1969 property changes the economic conditions with respect to the use of flow-through on existing property. New York quotes the Conference Report[1] to the effect that a taxpayer is not permitted to use accelerated depreciation unless it uses normalization but that this rule does not apply to a taxpayer presently using flow-through. However, this is not inconsistent with our permitting a change from flow-through to normalization.

6. PGW argues similarly that the Tax Reform Act did not confer on us additional power to permit an abandonment of flow-through in the absence of a justifying change in factual circumstances unrelated to the effect of the Tax Reform Act. We see no reason why the impact of the Tax Reform Act may not be a circumstance that might militate in favor of permitting Texas Gas to abandon flow-through accounting. As already noted, the Tax Reform Act permits the company to abandon flow-through with respect to post-1969 elective property. This changes the effect of liberalized depreciation with flow-through on the Company and its customers. For the reasons set forth in Opinion No. 578 we accordingly permitted Texas

[1] Conference Report No. 91-782, U.S. Code Congressional and Administrative News, p. A-785.

Gas to abandon flow-through for ratemaking and accounting and employ normalization.

The Commission further finds:

The assignments of error and grounds for rehearing set forth in the above applications for rehearing and motions for stay present no facts or legal principles which would warrant any change in or modification of Opinion No. 578 and order of June 3, 1970.

The Commission orders:

The applications for rehearing filed by Memphis, New York and PGW are denied.

By the Commission:

[SEAL] GORDON M. GRANT,
Secretary.

APPENDIX F

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 625, 26 U.S.C. 167(*l*), provides:

(a) IN GENERAL. Section 167 (relating to depreciation) is amended by inserting after subsection (k) (added by section 521) the following new subsection:

"(l) REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

"(1) PRE-1970 PUBLIC UTILITY PROPERTY.—

"(A) IN GENERAL.—In the case of any pre-1970 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—

"(i) a subsection (l) method, or

"(ii) the applicable 1968 method for such property. Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

"(B) FLOW-THROUGH METHOD OF ACCOUNTING IN CERTAIN CASES.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

"(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

"(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

"(2) POST-1969 PUBLIC UTILITY PROPERTY.—In the case of any post-1969 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—

"(A) a subsection (l) method,

"(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

"(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) PUBLIC UTILITY PROPERTY.—The term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

"(i) electrical energy, water, or sewage disposal services,

"(ii) gas or steam through a local distribution system,

"(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

"(iv) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

"(B) PRE-1970 PUBLIC UTILITY PROPERTY.—The term 'pre-1970 public utility property' means property which was public utility prop-

erty in the hands of any person at any time before January 1, 1970.

"(C) POST-1969 PUBLIC UTILITY PROPERTY.—The term 'post-1969 public utility property' means any public utility property which is not pre-1970 public utility property.

"(D) APPLICABLE 1968 METHOD.—The term 'applicable 1968 method' means, with respect to any public utility property—

"(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

"(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

"(iii) if neither clause (i) nor (ii) applies, a subsection (l) method.

In the case of any section 1250 property to which subsection (j) applies, the term 'applicable 1968 method' means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

"(E) APPLICABLE 1968 METHOD IN CERTAIN CASES.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (l) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be applicable 1968 method with respect to

such property and public utility property of the same (or similar) kind subsequently placed in service.

"(F) SUBSECTION (l) METHOD.—The term 'subsection (l) method' means any method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable solely by reason of the application of subsection (b)(4) or (j)(1)(C).

"(G) NORMALIZATION METHOD OF ACCOUNTING.—In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

"(H) FLOW-THROUGH METHOD OF ACCOUNTING.—The taxpayer used a 'flow-through method of accounting' with respect to any public utility property if it used the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

"(I) JULY 1969 ACCOUNTING PERIOD.—The term 'July 1969 accounting period' means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its

tax expense for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

"(4) SPECIAL RULES AS TO FLOW-THROUGH METHOD.—

"(A) ELECTION AS TO NEW PROPERTY REPRESENTING GROWTH IN CAPACITY.—If the taxpayer makes an election under this subparagraph within 180 days after the date of the enactment of this subparagraph in the manner prescribed by the Secretary or his delegate, in the case of taxable years beginning after December 31, 1970, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.

"(B) CERTAIN PENDING APPLICATIONS FOR CHANGES IN METHOD.—In applying paragraph (1)(B), the taxpayer shall be deemed to have used a flow-through method of accounting for its July 1969 accounting period with respect to any pre-1970 public utility property for which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

"(5) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions

of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to all taxable years for which a return has not been filed before August 1, 1969.

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SEP 22

MICHAEL RODAK, J

No. 72-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

72-488

TEXAS GAS TRANSMISSION CORPORATION,
Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-

TEXAS GAS TRANSMISSION CORPORATION,
Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Texas Gas Transmission Corporation (Texas Gas) hereby petitions for a writ of certiorari to review that portion of the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in *Memphis Light, Gas and Water Division* v. *Federal Power Commission* on February 18, 1972, setting aside the Commission's order permitting Texas Gas to change, for rate making purposes, its method of tax depreciation from liberalized depreciation with flow-through for its existing properties.

OPINIONS BELOW

The initial opinion of the Court of Appeals and its opinion on rehearing are not yet reported but are set forth in Appendix A and B respectively in the Petition being filed by the Solicitor General of the United States on behalf of the Federal Power Commission (FPC Petition). The initial opinion (Opinion No. 578) of the Federal Power Commission (R. pp. 100-111), and its opinion on rehearing (Opinion No. 578-A, R. pp. 145-149) are reported at 43 FPC 824 and 44 FPC 140, respectively, and are set forth in FPC's Petition as Appendix D and Appendix E, respectively.

JURISDICTION

The judgment of the Court of Appeals was entered on February 18, 1972 (FPC Petition, Appendix C). Petitions for rehearing filed by the Commission and Texas Gas were denied on May 11, 1972. On August 4, 1972, the Chief Justice extended the time for filing a petition for writ of certiorari to and including September 23, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, *et seq.*, 26 U.S.C. § 167(1) are set forth in the FPC Petition at Appendix F.

QUESTION PRESENTED

Whether Congress intended by Section 441 of the Tax Reform Act of 1969, to withdraw from the Federal Power Commission (and other agencies charged with similar regulatory responsibilities) the authority and

discretion to permit a utility to change, for rate-making purposes, its method of tax depreciation for existing property from liberalized depreciation with flow-through to liberalized depreciation with normalization or straight-line depreciation.[1]

STATEMENT

A. Background

Prior to the enactment of Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, the Commission had usually used the straight-line depreciation method for determining federal income tax expense. Under this method, annual depreciation is uniform over the asset's life. Section 167 authorized taxpayers to compute tax depreciation, in addition to straight-line, by one of several accelerated or "liberalized" depreciation methods. Under any of these liberalized methods, annual depreciation is higher in the asset's early years and lower in its later years than under the straight-line method, and conversely, the federal income tax expense is lower in the early years and higher in the later years. Under all the depreciation methods here involved—straight-line and liberalized—the aggregate tax depreciation over the life of an asset never exceeds its total depreciable value.[2]

In enacting Section 167, the Congress intended to increase available working capital for all segments of the American economy to assist in the modernization and expansion of industrial capacity. H. Rept. 1337,

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[1] The terms "existing property"; "expansion property"; "flow-through" and "normalization" as used in this Petition are the same as described in the FPC Petition.

[2] There is no question here with regard to book depreciation which still is largely determined on the straight-line method.

83d Cong.; S. Rept. 1662, 83d Cong., *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 316 F.2d 659, 662 (D.C. Cir. 1963).

In the early years following the enactment of Section 167, the Commission determined that the use of liberalized depreciation resulted in a tax deferral, and that the income tax expense allowed in the cost of service should be "normalized" for rate purposes, *i.e.*, the income tax allowed should be computed on the basis of straight-line depreciation and the difference between the taxes thus computed and the actual taxes payable under liberalized depreciation should be kept in a reserve account to be available, as needed, to pay the higher income taxes of later years. See, *e.g.*, *Amere Gas Utilities Co.*, 15 FPC 760, 781 (1956). In so doing the Commission reasoned that present rate payers would not benefit at the expense of future rate payers, and *vice versa*. This Commission position was affirmed by the Fourth Circuit as being a matter within the Commission's special expertise. See e.g., *City of Lexington* v. *F.P.C.*, 295 F.2d 109, 114 (4th Cir. 1961).

Several years later (1964), after its membership had changed substantially, the Commission (3-2) reversed this earlier decision by finding that the utilization of liberalized depreciation generally resulted in a permanent tax savings and directed that these "savings" should flow-through to the customers, in the form of reduced rates. *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 (1964) affirmed *sub nom.*, *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F.2d 318 (5th Cir., 1966), *cert. denied* 385 U.S. 847.

Two years later (1966), the Commission (3-2) decided that, for rate purposes, it would impute the use of liberalized tax depreciation to any company which

shifted from liberalized depreciation to straight line depreciation and would flow through the resulting imputed tax "savings" to the rate-payers. See *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), affirmed, 388 F.2d 444 (7th Cir., 1968), *cert. denied*, 392 U.S. 928.

The courts, in all three cases, recognized that the regulation of the tax depreciation policies followed by jurisdictional companies for rate purposes lay within the Commission's discretion.[8]

As we will show below, with the passage of the Tax Reform Act of 1969, a vital premise of the Commission's flow-through policy disappeared; the tax reduction ceased to be a "saving" and became a mere deferral.

B. Section 441(a) of the Tax Reform Act of 1969.

The legislative history, as well as the language of Section 441(a), establishes the real concern which the Congress had, over the loss of tax revenues as a result of the actions taken, or threatened, by regulatory agencies in the rate treatment of liberalized depreciation. As stated by the House Committee (H. Rep. No. 91-413; Part I, 91st Cong., 1st Sess., p. 132):

> "Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion; some estimates indicate that the loss might be con-

[8] The Commission has consistently regarded the treatment of liberalized depreciation in a regulatory context as a matter of administrative discretion. See, *e.g.*, *Alabama-Tennessee Natural Gas Co.*, 31 FPC at 216; *Natural Gas Pipeline Co.*, 33 FPC 574, 578 (1965), vacated on other grounds *sub nom. City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied sub nom. P.S.C. of Wisconsin* v. *F.P.C.*, 390 U.S. 945 (1968).

siderably closer to $2 billion per year. Your Committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow-through is unacceptable at this time."

In order to forestall this continuing loss of tax revenues, the House Ways and Means Committee proposed and the House adopted the following three general rules (*id.* at 133):

> "(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.
>
> (2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

These same three rules were proposed by the Senate Committee and adopted by the Senate:

> "Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:
>
> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.
>
> (2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must shift to the straight line method unless it continues to normalize as to that property.
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its cus-

tomers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property.

Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies)."[4]

The Senate Finance Committee, however, provided a *supplemental* privilege to regulated utilities by way of an election, with respect to *existing* as well as *new* property, which was not available under the House version (*id.* at 173):

"The Committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straightline method, *with or without the permission of the appropriate regulatory agency,* or permit it with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill)."[4] (Emphasis supplied)

The Conference Committee made no changes in the general rules. However, it did revise the election provided in the Senate bill to exclude existing properties from

[4] S. Rept. No. 91-552 91st Cong. 1st Sess. 172-73.

its coverage. See H. Rep. No. 91-782, 91st Cong., 1st Sess., pp. 150-154, 312-313.

C. The Proceedings Before the Commission

Prior to the enactment of the Tax Reform Act of 1969, Texas Gas, like most of the utilities regulated by the Commission, and under compulsion of *Alabama-Tennessee* and *Midwestern, supra,* was utilizing liberalized depreciation with flow-through. Also prior to the passage of the Tax Reform Act, Texas Gas filed, pursuant to Section 4(e) of the Natural Gas Act 15 U.S.C. § 717 c (e), a proposal to increase its rates which *inter alia* would permit it to recover the increased taxes associated with its request to return to a straight-line method of tax depreciation with respect to *all* of its qualified property. (R. 1399)

After the passage of the Tax Reform Act and during the course of the above described rate proceeding, Texas Gas advised the Commission of its intent to exercise the election provided in Section 441 and to use, with Commission permission, liberalized income tax depreciation with normalization for its *expansion* properties. However, Texas Gas requested Commission assurance, before it made the election, that it would be permitted to change to straight line, or alternatively and preferably, to normalization for its *existing* properties. If it made the election without such assurance, the Company urged, it would be confronted with a continual loss of income tax depreciation deductions, necessitating further and repeated applications for rate increases (R. 2694-5). In May, 1970, the Commission issued Order No. 404, 43 FPC 740, announcing its intention to permit companies subject to its regulation which invoked the election to use liberalized depreciation with normalization for the expansion properties.

In Opinion No. 578, issued on June 3, 1970, the Commission granted the Company permission to shift to normalization for the rest of its properties (FPC Petition, Appendix D). The Commission pointed out that its premise in *Alabama-Tennessee, supra,* that the use of liberalized depreciation resulted in permanent tax savings for companies with growing or stable plant, was no longer valid for companies, such as Texas Gas, which had elected to abandon flow-through for their expansion properties (*Id.* p. 62). As a result, the Commission found that requiring Texas Gas, nevertheless, to continue to use flow-through for its existing properties would result in the Company's tax component increasing constantly with a resulting continual need for increased rates (FPC Petition, App. D, pp. 63-64).

Accordingly, the Commission concluded that permitting Texas Gas, in such circumstances, to shift to normalization for its existing properties offered "more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases" (FPC Petition, App. D, p. 63). In addition, the Commission required Texas Gas to place the difference between the taxes due and the taxes allowed as a result of using normalization in a special reserve which would be excluded from the rate base on which the return allowed is computed with the result that the consumers would share in the benefits of normalization (FPC Petition App. D, p. 63).

Thereafter, on June 8, 1970, Texas Gas exercised its election not to have flow-through apply to its expansion property and commenced normalization of the tax expenses on all of its utility property as of January 1, 1970. The normalized taxes have been collected in Texas Gas' rates since January 12, 1970.

D. The Decision of the Court Below

The court below affirmed the Commission's action in Order No. 404 permitting companies on flow-through to use normalization for expansion properties (FPC Petition, App. A, pp. 20-29).[5] However, it set aside the Commission's action in Opinion No. 578 permitting Texas Gas to change to normalization for its existing properties holding that Texas Gas "... is specifically prohibited, under the final version of the bill ..." from abandoning flow through. (FPC Petition, App. A, p. 34). This is the keystone finding of the court's conclusion. It is based upon the premise that, in the final version of the Tax Reform Act of 1969, the Federal Power Commission lost its discretion to permit a regulated utility to switch from flow-through to normalization for rate-making purposes.

The court below expressly recognized that, under the House version of the Tax Reform Act, the Commission was "clearly justified" in permitting Texas Gas to change from flow-through to normalization:

> "Thus, under the House version of the bill, Texas Gas, since it had been using accelerated depreciation with flow-through, would have been required to continue doing so with respect to its 'existing' (including replacement) property unless the Commission permitted otherwise. If this had been the law enacted, the Commission's and Texas Gas' position here would have been clearly justified...." (FPC Petition, App. A. p. 32)

However, the court reasoned that the election provided by the Senate, and later limited by the Conference Committee to expansion property, eliminated the discretion with respect to existing property, which was built into

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[5] This is the subject of the Petition in No. 72-96 in which Texas Gas and the Solicitor General have filed briefs in opposition.

the House version, despite the clear language of the Senate Report which emphatically demonstrates that the Senate bill kept the core of the House bill intact:

> "Both the House bill and the committee amendments provide that in the case of existing property, the following rules are to apply:
>
> * * *
>
> "(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), *unless the appropriate regulatory agency permits a change as to that property.*" (*Emphasis supplied*) [6]

REASONS FOR GRANTING THE WRIT

1. The holding of the Court of Appeals that Section 441 of the 1969 Tax Reform Act operates to withdraw the Commission's authority to permit Texas Gas to change from flow-through to other methods of tax depreciation for its existing properties is, we submit, based on a gross misreading of that Section and its legislative history, which, if not corrected by this Court, may have important and far-reaching consequences.

The decision may have effects far beyond the wholesale gas and electric business regulated by the Commission. The provisions of Section 441(a)(3)(A) are to apply to all properties used predominantly in the trade or business of the furnishing or sale of:

(a) electrical energy, water, or sewage disposal services;

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[6] S. Rep. No. 91-552 [To Accompany H.R. 13270] 91st Cong., 1st Sess. 172-73. The parenthetical phrase clearly refers to the 180-day election which was a separate, distinct and additional option being proposed by the Senate.

(b) steam or gas through local distribution systems;

(c) telephone services and other communication services if furnished or sold by Comsat; and

(d) transportation of gas or steam by pipeline.

The court's holding could thus operate to withdraw authority to permit changes from flow-through by all regulatory agencies, *state* as well as *federal,* having jurisdiction over the rates of companies engaged in the businesses listed above.

Further, the court's holding would substitute a flat rule permitting, at most, only very limited exceptions in an area which traditionally has been accepted as properly one for exercise of agency expertise. As a result, it would make it difficult, if not impossible, for the Comission to make the appropriate *ad hoc* adjustments which, in its view, may be called for, particularly in the natural gas industry where there is an urgent need to stimulate the development of ways and means of alleviating the present critical shortage of natural gas.[7] In addition, the court's decision would frustrate, in large measure, the express Congressional intent underlying Section 441 to reduce the future losses of tax revenues resulting from the recent trends of regulatory agencies to change to flow-through.

[7] Under the double-declining balance method of liberalized depreciation, a point of time is reached where it becomes more economic to revert to a straight-line method of tax depreciation. This is commonly referred to as the "cross-over point." Under the decision of the court below, regulated utilities on flow-through would be prohibited from abandoning liberalized depreciation despite the fact that all would agree that the cross-over point had been reached and that the change to a straight-line method would be in the public interest.

Also, the court's holding would mean that companies, which exercised the election to shift to normalization for their expansion properties, would be confronted with a substantial and continual reduction in tax depreciation necessitating repeated applications for rate increases and resulting rate instability for their customers. And since all but two of the natural gas pipeline companies on flow-through exercised this right of election, the increased number of rate filings would aggravate the Commission's already heavy administrative burdens.

2. In concluding that Section 441 of the 1969 Tax Reform Act withdrew authority from the regulatory agencies to permit utilities on flow-through to change to other methods of tax depreciation, the court below misread the Senate Committee Report. As discussed earlier herein, the Senate version did not propose to limit agency discretion to permit companies on flow-through to change to straight-line or nomalization. To the contrary, the Senate Committee accepted the third general rule as set out in the House version. It undertook, *in addition,* to provide a right of election for companies on flow-through.[8]

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[8] Accordingly, since the House and Senate versions were in agreement on the third general rule for companies of flow-through, and their disagreement extended only to the additional right of election for these companies proposed by the Senate, the Conference Committee refrained, as it was required to do (See Section 136 of the Legislative Reorganization Act of 1946, 2 U.S.C. 190c(a)), from revising the provisions relating to the general rule and limited its revision to only the separate right of election. See General Explanation of the Tax Reform Act of 1969, H. R. 13290, 91st Cong., Public Law 91-172, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, p. 153.

Thus, the Senate Committee Report explicitly points out that its "committee amendments" parallel "the House bill" in providing:

> "that in the case of existing property, the following rules are to apply:
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> * * * *
>
> "(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property." (S. Rep. No. 91-552, *supra*, at pp. 172-173).

Continuing, the Senate Report goes on to describe the proposed election as a "differ[ence] in one principal area" (S. Rep. No. 91-552, *supra*, at p. 173), with the difference, we submit, being the absence from the House bill of a provision granting a similar right of election.

Contrary to the court below (FPC Petition, App. B. pp. 43-46), the election which the Senate thus proposed to grant to utilities on flow-through (S. Rep. No. 91-552, *supra*, at p. 173) did not consist of two separate and distinct alternatives. Rather, the two alternatives were mutually-interdependent parts of a single package designed to exert pressure on the regulatory agencies to permit utilities on flow-through to change to normalization by putting them on notice that if they refused permission for changes to normalization, the utility could nevertheless change to straight-line *without their permission*. The proposed election was thus different from the third general rule which requires *agency permission* before a utility on flow-

through could change *either* to normalization *or* to straight-line.

Construing the Senate Report as intending the proposed election as an *addition* to, rather than as a *substitute* for, the third general rule for utilities on flow-through, removes the ambiguity which would otherwise arise from the parenthetical phrase ("except as provided under the committee amendments which are discussed below") included in the Senate description of the third general rule (*supra*, pp. 6, 7). And it serves to explain why neither the Conference Committee Report nor the managers of the bill in both Houses undertook to offer any justification for the drastic change in the legislation (as found by the Court below) as their responsibilities required, had the Court-determined result in fact been intended.

3. Finally, the conclusion of the court below is not supported by the Congressional intent "in general to freeze" the existing situation regarding methods of depreciation (FPC Petition, App. A, pp. 34-36). This general characterization was not intended to supersede the three general rules *expressly* provided both by the House and by the Senate.

In addition, the court's conclusion in this respect would appear to be self-contradictory. As heretofore indicated (p. 10), the court has found that the Commission's action would have been completely justified under the House version of the Tax Reform Act, even though the "freeze" language, upon which the Court relies, was contained in the accompanying House Report. It is perfectly understandable that the House Committee would describe the restrictions which it was

placing upon regulatory agencies as an action ". . . . in general to 'freeze' the current situation . . .". It is quite a different thing, however, to construe such language to mean a "complete freeze" as did the court below. Such a construction completely ignores and nullifies the Congressional intent as clearly expressed in the three general rules.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF OF MEMPHIS LIGHT, GAS AND WATER DIVISION IN OPPOSITION

OPINIONS BELOW

The initial opinion of the Court of Appeals (App. A, Pet. for Cert., pp. 17-39) and its opinion on rehearing (App. B, Pet., pp. 41-53) are not yet reported. The initial opinion (No. 578) of the Federal Power Commission (App. D, Pet., pp. 57-66) and its opinion on rehearing (No. 578-A; App. E., Pet., pp. 67-71) are reported at 43 FPC 824 and 44 FPC 140.

JURISDICTION

The judgment of the Court of Appeals was entered on February 18, 1972 (App. C, Pet., pp. 55-56), and the Commission's petition for rehearing was denied on May 11, 1972 (App. B, Pet., pp. 41-53). On August 4, 1972, the Chief Justice extended the time for filing a petition for a writ of certiorari to September 23, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 625, 26 U.S.C. 167(1), is set forth in App. F, *infra*, pp. 73-78.

QUESTION PRESENTED

Whether the Court below correctly construed Section 441(a) of the Tax Reform Act of 1969 as having retained the existing tax depreciation practices of natural gas pipeline companies with respect to properties held prior to January 1, 1970, and replacements of such properties.

STATEMENT

The issue in this case relates to the proper construction of Section 441(a) of the Tax Reform Act of 1969, and its effect upon the regulatory practices and policies of the Federal Power Commission.

The United States Court of Appeals for the District of Columbia held that the effect of the statute was to permit certain regulated utilities to change their depreciation practices with respect to new property acquired after December 31, 1969 which increased the produc-

tive or operational capacity of the company and did not represent replacement of existing capacity. The Court held that the new Act did not permit such change in depreciation practices for any other properties of the regulated utilities.

The effect of this ruling was (1) to avoid wide-spread and substantial utility rate increases at the present time, (2) to permit utilities gradually to change over from accelerated depreciation with flow-through to accelerated depreciation with normalization,[1] as new expansion properties were added to their systems after 1969.

The Opinion below reversed Opinion No. 578 and 578A of the Federal Power Commission, which construed Section 441(a) of the Tax Reform Act of 1969 as having placed the Commission in a position where practical consideration made it encumbent upon the Commission to permit regulated utilities to use accelerated depreciation with respect to all of their properties, both new and old, and to normalize their tax payments for the purpose of computing cost of service to their customers (Pet., App. D, pp. 64-65).

The practical effect of the Commission's interpretation of the new Act, as conceded in the Petition (p. 15), is to necessitate present rate increases by practically all of the interstate natural gas pipelines, as well as many other regulated utilities in the country.

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[1] As explained in the Commission's Petition For Certiorari (pp. 4-5), when the tax benefits of accelerated depreciation are "flowed through", the customers of the regulated utilities receive the benefits in the form of lower cost of service; when those benefits are "normalized", the regulated utility computes its taxes with the use of liberalized depreciation, but computes its cost of service as if it had paid taxes on the basis of straightline depreciation.

ARGUMENT

The result reached by the Court of Appeals accords precisely with the stated purposes of Congress in the legislative history of Section 441(a) of the Tax Reform Act of 1969, and produces precisely the result which Congress intended and expected from that Act. The contrary interpretation proposed by the Federal Power Commission would create the very situation which Congress sought to avoid and thought it had avoided.

The overall purpose of Section 441(a) was to stop the current trend which indicated that regulated utilities were being required by their regulatory Commission to change from accelerated depreciation with normalization to accelerated depreciation with flow-through. The reason for stopping the trend was that there was a greater revenue loss to the Treasury from the use of flow-through than from the use of normalization.[2]

This reason was succinctly stated in the Senate Finance Committee Report accompanying HR 13270:

> General reasons for change.—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this

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[2] This is because the normalization method permits the utility to pocket the tax savings resulting from use of liberalized depreciation, and the increased revenues constitute taxable income.

> item is unacceptable at this time. On the othe hand, a rule requiring all such utilities to shift t straight line depreciation would place regulate utilities at an unfair competitive disadvantage both in terms of the sale of their products or serv ices and their attractiveness to equity investors U.S. Code Cong. & Ad. News, Vol. 2, 1969, p. 2204

A similar statement was made by the House Committee On Ways and Means (U.S. Code Cong. & Ad News, Vol. 2, 1969, pp. 1782-3).

While the legislation was under consideration in Committee, the Federal Power Commission suggested the problem be solved by simply requiring all regulated utilities to switch to straight-line depreciation. This suggestion was expressly rejected by the House Committee which stated in its Report:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases. (U.S. Code Cong. & Ad. News, Vol. 2, 1969, p. 1783)

Time and again the Committees of both Houses reiterated their desire to avoid, as a consequence of Section 441(a), any substantial present rate increases. The Congress did not desire to institute a substantial change in depreciation practices, but rather to "freeze" the situation as it was at the time the legisla-

tion was passed. Thus, the House Ways and Means Committee stated at Page 132 of its Report accompanying HR 13270:

> Accordingly, *your committee has determined in general to 'freeze' the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more healthy utility industries. (House Report of Committee on Ways and Means [to Accompany HR 13270], 91st Cong. 1st Sess., p. 132; U.S. Code Cong. and Adm. News, 1969, Vol. 2, p. 1783). (Italics added)

The Senate Report concurred, saying (U.S. Code Cong. and Adm. News, 1969, Vol. 2, pp. 2204-5, 91st Cong., 1st Sess.):

> Accordingly, the committee agrees with the House that *it is appropriate to in general 'freeze' the current situation* regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. (Italics added)

In the course of the tax bill through the two Houses of Congress, an attempt was made in the Senate to permit the regulated utilities to elect, within 180 days from the enactment of the Act, to shift from the flow-through to the straight line method, with respect to all of their properties, both new and existing (U.S. Code Cong. & Ad. News, 1969, p. 2206). This, however, would have defeated the purposes above set forth, in that it would have permitted the regulated utilities to normalize with respect to all of their properties, which would have almost the identical effect on rates as if the utilities had used straight line depreciation.[3] Accordingly, the House refused to concur, and the ultimate result was to

[3] The effect of normalization is not quite the same as that of straight-line depreciation, because the rate payer is not required to pay a return on his contribution of fictional taxes to the utility.

permit an election only with respect to new property which increased the capacity of the taxpayer and did not represent replacement of existing property (Section 441(a)(4)(A), Pet. App. F, p. 77). The restriction of the election to post-1969 expansion property, of course, meant that it would have no immediate rate impact. Each year thereafter, as utilities added expansion properties, and retired pre-1970 properties, the change-over to normalization would gradually take effect.

When the bill was molded into its final form, the Congress was still of the firm impression that it had avoided any wide-spread substantial utility rate increases. The report of the Staff of the Joint Committee states that the bill had been drawn:

> . . . in a way that (with very few exceptions) will require no increase in utility rates, because of the tax laws, since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations. (Summary HR 13270 Tax Reform Act of 1969 by Staff of Joint Committee on Internal Revenue Tax, p. 73).

The Opinion of the Court of Appeals, after specifically citing the above statement, held:

> There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow-through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property. According to Congress, the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its

pre-1970 and post-1969 non-expansion property, is the income taxes actually paid (Pet., App. A, p. 36).

The complaint by the Commission against the judgment of the Court of Appeals is that it fails to construe the new tax Act in such a way as to require the immediate, substantial, wide-spread rate increases which would inevitably result from the use of fictitious straight-line tax depreciation in computing cost of service.

It is submitted that the result of the Court of Appeals accords precisely with the intent of Congress, and the result desired by the Federal Power Commission accomplishes the very rate increases Congress desired to prevent and treats the customer as if the utilities were on a straight-line depreciation basis, a proposal expressly rejected by Congress.

CONCLUSION

Since the opinion of the Court of Appeals accords with the clearly expressed intent of Congress, and the position taken by the Commission is totally inconsistent therewith, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner,*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF OF MEMPHIS LIGHT, GAS AND WATER DIVISION IN OPPOSITION

OPINIONS BELOW

The initial Opinion of the Court of Appeals and its Opinion on rehearing are not yet reported, but are set forth as App. A and B of the Petition for Certiorari filed contemporaneously with the Petition in this docket, from the same Court of Appeals' Opinion. The Opinions No. 578 and 578A of the Federal Power Com-

mission are reported at 43 FPC 824, and 44 FPC 140 and are set forth in App. D and E of the Commission's Petition for Certiorari.

STATEMENT

The question raised by the Petition for Certiorari filed by Texas Gas Transmission Corporation is substantially the same as that set forth in the contemporaneous Petition for Certiorari of the Federal Power Commission.

The Memphis Light, Gas and Water Division has filed its Brief In Opposition to the Petition of the Federal Power Commission, and it adopts the same brief as its response to the Petition of Texas Gas Transmission Corporation in this docket.

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Nos. 72-486 and 72-488

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

FEDERAL POWER COMMISSION,

Petitioner

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

TEXAS GAS TRANSMISSION CORPORATION,

Petitioner

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK IN OPPOSITION

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MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (FPC Pet. Apps. A and B, pp. 17-53) are not yet reported. The opinion of

the Federal Power Commission, No. 578 (FPC Pet. App. D, pp. 57-66) is reported at 43 FPC 824 and its opinion No. 578-A on rehearing, (FPC Pet. App. E, pp. 67-71) is reported at 44 FPC 140.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972 and the Commission's petition for rehearing was denied on May 11, 1972. On August 4, 1972, the Chief Justice extended the time for filing a petition for a writ of certiorari to September 23, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 625, 26 U.S.C. 167(1), is set forth in App. F, pp. 73-78 of the Petition in No. 72-486.

QUESTION PRESENTED

Whether, under the provisions of Section 441(a) of the Tax Reform Act of 1969 providing that natural gas pipelines and certain other utilities who had been utilizing liberalized depreciation with flow through accounting could elect within an 180 day period to shift to normalized accounting for property acquired after January 1, 1970 as long as the property increased the pipeline's productive or operational capacity but did not represent replacement capacity, the Federal Power Commission could authorize a pipeline also to shift to normalized accounting, and thereby increase its rates, with respect to existing and non-expansion property.

STATEMENT

Among the costs of service which a regulated natural gas pipeline or other utility are permitted to charge to their customers in fixing just and reasonable rates are the federal and state taxes, including income taxes, they are required to pay annually. But it is established law that, except to the extent Congress otherwise directs,[1] it is impermissible for the Federal Power Commission to include in a pipeline's cost-of-service an allowance for taxes not actually paid as a result of special tax provisions permitting a pipeline or other regulated company to avoid or reduce the taxes it would otherwise have been required to pay. See *Federal Power Commission v. United Gas Pipe Line Co.*, 386 U.S. 237, 244, 247; *El Paso Natural Gas Co. v. Federal Power Commission*, 281 F.2d 567, 573, (C.A. 5), *certiorari denied, sub nom. California v. Federal Power Commission*, 366 U.S. 912.

In the case of the utilization of liberalized depreciation under Section 167 of the Internal Revenue Code, the Commission originally held that the pipeline's cost allowance for tax purposes should be calculated as though it had paid the higher taxes which would have resulted from its utilization of a straight-line method. See *Amere Gas Utilities Co.*, 15 FPC 760. It did so in part because of its view that Congress had so directed in adopting the provisions for liberalized depreciation in the 1954 Revenue Act, and in part because of a belief that a pipeline's utilization of liberalized depreciation resulted

[1] Thus, in adopting the Investment Tax Credit as part of the Revenue Act of 1964, 78 Stat. 35, 26 U.S.C.A. 38 (historical note), the Congress expressly precluded any federal agency from reducing the pipeline's income tax allowance in any rate case cost-of-service by the amount of the credit, unless the pipeline consented thereto.

in a tax deferral rather than a tax savings. This view of the situation was accepted by several courts of appeals. See *El Paso Natural Gas Co. v. Federal Power Commission, supra; Cities of Lexington, etc., Ky. v. Federal Power Commission*, 295 F.2d 109 (C.A. 4). But in 1964 in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, the Commission after a comprehensive reevaluation of the situation concluded that Congress in 1954 had not mandated that pipelines be afforded a cost allowance in their rates for taxes not paid, and that when the pipeline's overall tax liability, rather than its obligations with respect to particular items of property, were considered, the utilization of liberalized depreciation, at least for those pipelines maintaining a growing or stable total plant investment, would result in permanent tax savings rather than a mere tax deferral. It accordingly determined that pipelines using liberalized depreciation should "flow through" the resultant tax savings to income, and that the tax allowance in their costs-of-service should be the actual amount of taxes paid. These determinations were expressly upheld in *Alabama-Tennessee Natural Gas Co. v. Federal Power Commission*, 359 F.2d 318 (C.A. 5), *certiorari denied*, 385 U.S. 847. See also *City of Chicago v. Federal Power Commission* 385 F.2d 629, 633-635 (C.A.D.C.); *Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444, (C.A. 7), *certiorari denied*, 392 U.S. 928.

This was the situation which prevailed at the time of Congress' consideration of the Tax Reform Act of 1969. There is no indication that it was one to which Congress objected. The Congress was, however, disturbed by suggestions that, as a result of indications that the Federal Communications Commission and certain state commissions might impute liberalized depreciation with flow through to the components of the Bell System,

those corporations might switch from straight line to liberalized depreciation at a cost to the Treasury of more than a billion dollars. See House Report No. 413, 91st Cong., 1st Sess., p. 131-132. It also was not prepared to accept the recommendation of the Federal Power Commission that pipelines be required to utilize straight line depreciation in the future, in part because "this would result in prompt, substantial, and widespread utility rate increases." *Id.* at p. 132. Accordingly, it adopted provisions regarding the use of liberalized depreciation by regulated utilities such as natural gas pipelines which were calculated "in general to 'freeze' the current situation regarding methods of depreciation," *Ibid.* See also S. Rep. No. 552, 91st Cong., 1st Sess., p. 172.

The issue in this proceeding is the extent to which the Congress made an exception to this general rule to permit pipelines who were on liberalized depreciation with flow through to switch, with the Commission's approval, to normalized accounting, and to increase their rates to include an allowance for the difference between the taxes they actually paid and those they would have paid if they had been utilizing straight line depreciation. The Federal Power Commission, in a proceeding involving a rate increase filing by the Texas Gas Transmission Corporation ("Texas Gas"), concluded that Texas Gas should be permitted to shift to normalization from flow through with respect to all of its property upon which it was and intended to continue to take liberalized depreciation (FPC Pet., App. D, pp, 57-66). The effect of this action was to increase Texas Gas' rates by $4,400,000, most of which related to the increased tax allowance relating to the pipeline's existing plant (R. 2757).

On review, the Court of Appeals for the District of Columbia, after an exhaustive analysis of the language

and legislative history of the Tax Reform Act of 1969, concluded that the bill, as it emerged from the Conference between the Senate and House and as subsequently enacted, deliberately restricted any such option to property acquired by the pipelines after January 1, 1970, which increases their "productive or operational capacity ... and does not represent replacement of existing capacity."[2] To extend such an option to existing non-expansion property would, the Court held, make "meaningless" the express action of the Congress in limiting the scope of the "election" available to pipelines already on liberalized depreciation with flow through, and result in the same type of massive rate increases which had led the Congress to reject the Commission's proposal to require a shift to straight line depreciation. (Under the Commission's 1969 tax proposal, however, the increased rates to pipeline customers would at least have been offset by increased tax revenues, whereas under the Commission's interpretation of the statute, both the Treasury and rate payers would suffer.) It is this determination which the instant petitions seek to have this Court review.[3]

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[2] In view of its construction of the Tax Reform Act of 1969 the Court of Appeals did not find it necessary to pass upon a number of other procedural and substantive challenges to the Commission's decision which had been raised by Memphis Light, Gas and Water Division and the Public Service Commission for the State of New York, the petitioners below.

[3] In No. 72-96, Memphis Light, Gas and Water Division sought review of the Court of Appeals holding, in the same opinion below, that the Commission properly authorized Texas Gas to shift to normalization with respect to its post-1970 expansion property. Certiorari was denied in this case on October 16, 1972.

ARGUMENT

The Court below held that the Tax Reform Act of 1969 permits natural gas pipelines and similar utilities to raise their rates, by shifting from a flow through to a normalized method of accounting for the use of a liberalized depreciation of property for federal tax purposes, only with respect to new expansion property which increases the pipeline's production and operational capacity. In unanimously rejecting the Commission's view that pipeline's utilizing liberalized depreciation could also shift to normalization with respect to their existing plant, the Court acted in accord with the Congressional intent to "in general freeze the current situation regarding methods of depreciation,"[4] an intent which was in turn motivated by Congress' dual objectives of minimizing potential losses to the Treasury or massive increases in utility rates, both of which consequences it feared might otherwise result from regulatory actions, and which led the Congress consciously to restrict agency discretion in a number of aspects. Its decision is clearly correct, and raises no issue of general significance calling for this Court's plenary review.

1. The arguments of the petitioners rest on the fact that the House and Senate versions of the bill both would have authorized the regulatory agencies to permit a company which had been utilizing liberalized depreciation with flow through accounting to shift to normalization with respect to all of its property.[5] Both the

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[4] H. Rep. No. 413, *supra*, at p. 133; S. Rep. No. 552, *supra*, at p. 172.

[5] The Commission does not contend that Congress could not limit its regulatory discretion through an amendment of the applicable tax laws. On the contrary, its brief in opposition in No.

Commission and Texas Gas ignore the very much more limited election to shift from liberalized depreciation with flow through which emerged from the Conference and was ultimately adopted into law. This election was expressly limited to post-1969 expansion property, with the Conference Report noting that "Even in the case of new property, however, the right to change over from the flow through method is to be available only to the extent that the new property increases the productive or operational capacity to the company." H. Rep. No. 782, 91st Cong., 1st Sess., pp. 312-13.

The petitioners attempt to avoid the effect of the Conference Report, and the language of the Act which resulted therefrom, by suggesting that the 180 day "election" which the Senate bill provided for any shift from liberalized depreciation with flow through was merely an "additional" option, unrelated to the provision in the House bill which would have authorized the Commission to permit a shift to normalization for all of a pipeline's property, new and old. Accordingly, it is contended, the Conference's later limitation of the election to new expansion property did not affect the Commission's discretion to authorize a similar shift with respect to existing and non-expansion property. But the Senate Report does not suggest that it was providing any additional benefit to the pipelines by its 180 day election provision, which it expressly stated was to apply "both as

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72-96 contended that Section 441(a) of the Tax Reform Act of 1969 precludes the Commission from exercising the authority it otherwise had (see *Midwestern Gas Transmission Co. v. Federal Power Commission, supra*) to impute the use of liberalized depreciation with flow through to utilities electing to abandon liberalized depreciation for new expansion property, despite the absence of any express prohibition in the language of the statute.

to new and existing property." S. Rep. No. 552, 91st Cong., 1st Sess., pp. 173-174. Instead it stated that the Senate and House bills "differ" in this "principal area." *Ibid.*

Moreover, as the Court of Appeals indicated (FPC Pet. App. A, p. 38), the construction urged by the Commission and Texas Gas renders "meaningless" the Conference's later action in limiting the election to new expansion property. On the other hand, the construction adopted by the court below is clearly more consistent with the general intent of the Congress to "freeze" the existing situation to avoid either precipitate losses to the Treasury or rate increases to gas consumers. For, while a shift to normalization with respect to new expansion property would have only a gradual effect upon pipeline rates, an unlimited changeover such as the Commission here approved, but Congress acted to forestall, could only serve to add immeasurably to the existing inflationary pressures.

2. Neither the Commission nor Texas Gas has shown that any question of sufficient importance to warrant plenary review by this Court is presented by the Court of Appeals' unanimous construction of the Tax Reform Act of 1969. This Court, in the past, has consistently rejected efforts to review lower court decisions on the rate effect of liberalized depreciation, even where they mandated a significant change in existing industry practices. See *Alabama-Tennessee Natural Gas Company v. Federal Power Commission*, 359 F.2d 318 (C.A. 5), *certiorari denied*, 385 U.S. 847; *Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444, *certiorari denied*, 392 U.S. 928; see also *El Paso Natural Gas Co. v. Federal Power Commission*, 281 F.2d 567 (C.A. 5), *certiorari denied sub nom., California v. Federal Power Commission*, 366 U.S. 912. The lower court's conclusion

here that the Tax Reform Act of 1969 precludes pipelines already using liberalized depreciation and continuing to do so from raising their rates by shifting from flow through to normalized accounting for their existing and non-expansion property, certainly raises no greater public issues.

The Commission suggestion that the decision below impairs its ability "to promote rates" (FPC Petition, p. 10)[6] is without substance. The use of liberalized depreciation by a pipeline with respect to all of its eligible property does not cease to provide permanent tax savings because the pipeline may have the right to treat new expansion facilities, for accounting and rate purposes, as though it had paid taxes on a straight-line basis: it is the continued use of liberalized depreciation rather than the method of accounting therefore which results in the tax savings. There is thus no basis for the Commission's unsupported assumption that permitting present rate increases will avoid future rate increases which would otherwise be necessitated.

On the contrary, even if it was proper to revert to the discredited concept that the actual long range effect of a

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[6]The Commission petition characterizes its action as "perhaps necessitating present rate increases (rather than deferral to future consumers of payments for present tax expenses)" (Petition, p. 15). In fact, the immediate rate increase effect of its action is certain—in the case of Texas Gas approximating $4,400,000—while, as the Commission itself recognized (FPC Pet. App. pp. 63-64), even if its analysis is confined to the pipeline's old and non-expansion plant, (but see text, *infra* at 11), there is no certainty that there will be any offsetting future cost increases. Moreover, any such future increases would *not* involve future rate payers paying for the pipeline's present tax expenses, but only for such increases as might actually be incurred at such time.

company taking liberalized depreciation can be analyzed on a unit of property basis, or through segregated consideration of various portions of a company's property,[7] there is no reason to believe that there will be any net increase in future taxes as a result of the use of liberalized depreciation. For the rate base applicable to such property at the future date when higher taxes would theoretically be due thereon—which in the case of Texas Gas is estimated to be thirteen years after the rate case test year—would be substantially less than that upon which the higher present calculations are made. Moreover, the Internal Revenue Service treats as present income any revenues a pipeline is permitted to collect because its rates have been calculated as if it depreciated its property on a straight line rather than liberalized basis. Accordingly, in order to make up for this tax-on-tax effect, the immediate increase in the pipeline's rates is substantially more than the difference between the taxes actually paid and those it would have paid on a straight line basis.

[7] But see *Alabama-Tennessee Natural Gas Co. v. Federal Power Commission, supra*, 359 F.2d at 328.

CONCLUSION

For the reasons set out above, the petitions for a writ of certiorari should be denied.

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IN THE

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OCTOBER TERM, 1972

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TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*,

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MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

REPLY BRIEF OF TEXAS GAS TRANSMISSION CORPORATION

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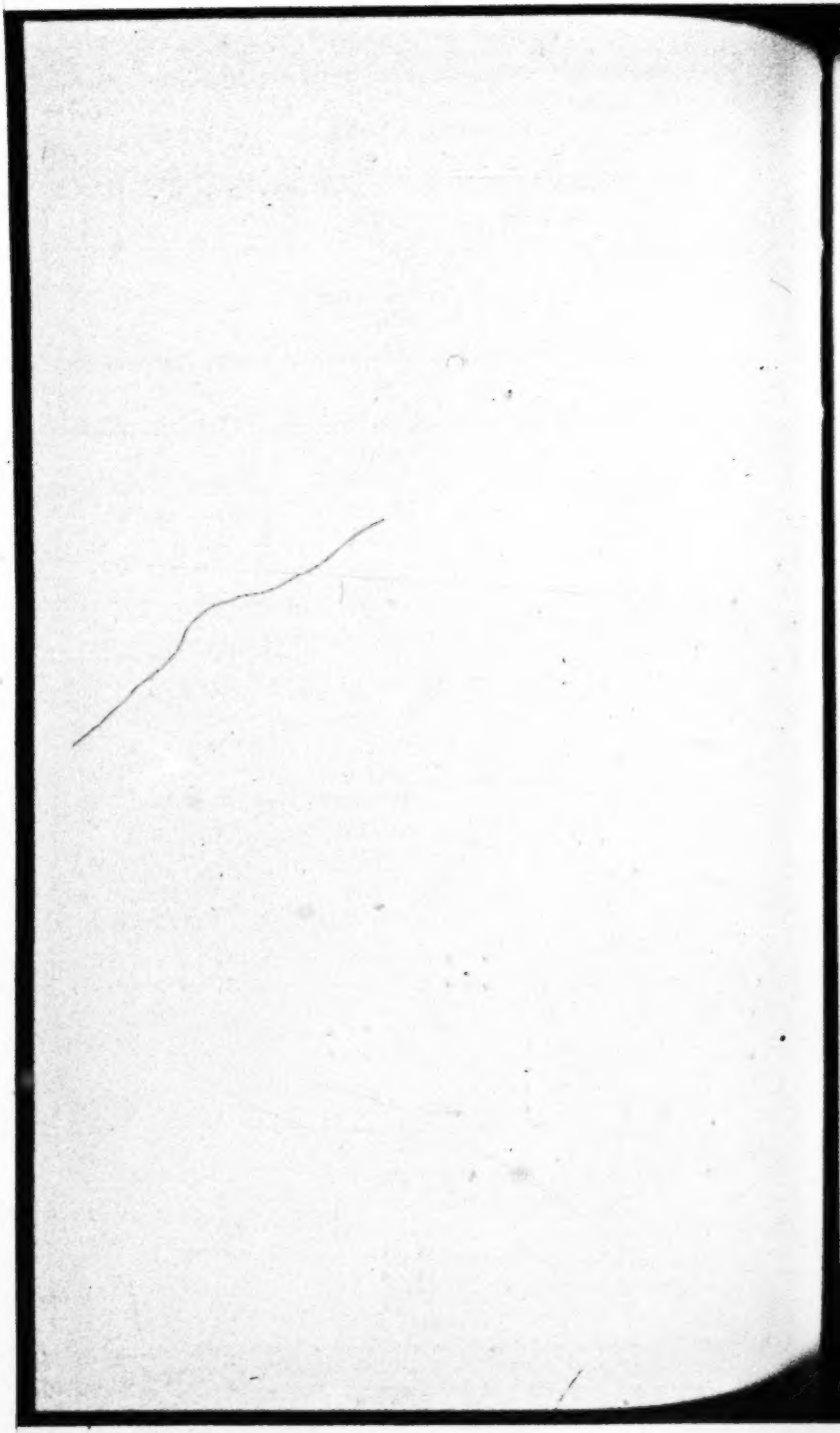

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REPLY BRIEF OF TEXAS GAS TRANSMISSION CORPORATION

INTRODUCTION

This Reply Brief is being filed pursuant to Rule 24.4 of the Rules of this Court. Two points have been raised in the briefs in opposition which deserve a reply under that Rule.[1]

[1] Other arguments have been adequately answered in the petitions filed by Texas Gas and the Solicitor General on behalf of the Federal Power Commission in the companion case at No. 72-486. For example, we have shown that the difference in taxes between straight line and normalization is not "pocketed" by the utility, but rather is placed in a restricted reserve to pay future taxes (Texas Gas' Pet. p. 4). We have also shown, contrary to the assertion of New York, that the cost to the consumer under normaliza-

Importance of Question

The first relates to the argument by the Public Service Commission of New York (New York) (Br. in Opp., pp. 9, 10) that the question presented is not of sufficient importance to warrant review by this Court and that, in the past, this Court has consistently rejected efforts to review lower court decisions on the rate effect of liberalized depreciation, citing, *inter alia, Alabama-Tennessee Natural Gas Company* v. *F.P.C.*, 359 F.2d 318 (5th Cir. 1966); *cert. den.*, 385 U.S. 847.

But the question here, however, is far different from the questions presented in the earlier cases cited by New York. In the *Alabama-Tennessee* case, for example, the court of appeals found that the question of normalization versus flow-through with respect to liberalized depreciation was a matter within the *discretion* of the appropriate regulatory agency. In opposing certiorari in that case, the Solicitor General of the United States, on behalf of the Federal Power Commission, stressed this very point (FPC Br. in Opposition in No. 286, Oct. T, 1966, at pp. 7-8):

> "The question of the appropriate treatment for rate-regulation purposes of tax reductions resulting from the use of the liberalized depreciation method is, concededly, a recurring one of general interest and importance in the regulatory com-

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tion would be *less*, not *greater*, than under straight line depreciation since the reserve is deducted from the utility's rate base (Id. p. 9.) We have also demonstrated the invalidity of the "freeze" argument (Id. pp. 15, 16); even the court below found that under both the House and Senate versions of Section 441, the Commission action would have been clearly justified despite the presence of "freeze" language in the House and Senate Reports. (Ibid.)

munity; and the present case represents a change in the thinking of the Federal Power Commission on the subject. Nevertheless, we do not think that the case calls for further review by this Court. The issue of flow-through v. normalization is basically one for resolution through the exercise of administrative discretion. When certiorari was sought in 1961 by the State of California, in the *El Paso* case, to review the Commission's earlier choice of normalization over flow-through, we stated:

> "* * * Such a choice is not one which warrants review by this Court. Under the same principle, the choice is one which can be changed by the Commission should it become convinced the other method is preferable. * * * [*California* v. *Federal Power Commission*, 366 U.S. 912, O.T. 1960, No. 599, Brief in Opposition for Federal Power Commission, pp. 11-12]'."

In the instant cause, the Commission had undertaken to exercise the administrative discretion which it clearly had, previously, and which it believed was unimpaired by the enactment of the Tax Reform Act of 1969. However, the court below has held that the enactment of Section 441 of that Act operated to withdraw and destroy the Commission's discretion to permit changes in tax depreciation practices for rate making purposes. Thus, we are not concerned here with just a tax question. Rather, we are concerned with the survival of the discretionary powers of regulatory agencies to exercise their expertise in regulating utilities subject to their jurisdiction. And in this regard, it is our position that neither the Tax Reform Act nor its legislative history provides any basis for the holding of the court below that Congress withdrew and eliminated such agency discretion. Patently, therefore, the

question presented in the instant cause is substantially different than the question as presented in earlier cases involving liberalized depreciation.

The question whether Congress has withdrawn this Commission discretion is of particular importance at this time when there is a critical shortage of natural gas in the United States,[2] and it is imperative that the Commission have wide latitude in the use of its expertise in the selection of the course best designed to alleviate that shortage.[3] Accordingly, any holding that such discretion of regulatory agencies has been withdrawn should be made only on the basis of a most clear expression of Congressional intent. Here, there is no such expression of Congressional intent; to the contrary, the legislative history, properly read, clearly demonstrates the intent of Congress to fully preserve this administrative discretion.[4]

Congressional Rejection of FPC Proposal To "Require" Utilities To Shift To Straight Line Depreciation

The second point relates to the argument of Memphis Light, Gas and Water Division (Memphis) that the action of the Commission "... treats the customers as if the utilities were on a straight-line basis, a proposal expressly rejected by Congress." (Br. in Op., p. 8). This is Memphis' principal argument and it is

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[2] *F.P.C.* v. *Louisiana Power and Light Co., et al.*, decided June 7, 1972 (Slip Op., p. 4, fn. 2).

[3] While the reserve for deferred taxes (fn. 1, p. 1, *supra*) cannot be reflected as income, the funds can be used, on an interim basis, for general corporate purposes such as exploration and development of gas reserves; the construction of facilities to acquire new gas reserves, etc.

[4] Texas Gas' Pet. pp. 6, 7; FPC Pet. pp. 6; 11-14.

based upon the suggestion which the Federal Power Commission (Commission) made to the Congress which would *require* all utilities to use straight-line depreciation.[5] Since the Commission's suggestion, in this respect, was rejected by Congress, Memphis argues that the position of the Commission in the instant cause is precisely what Congress was trying to avoid.

But, contrary to Memphis' argument, the effect of the Commission's order here is not to revive the suggestion, made by the Commission and rejected by Congress. Memphis overlooks the fact that, whereas the Commission's suggestion would require *all* utilities to shift to straight line depreciation, no such requirement would be imposed under the Commission's reading of Section 441 of the 1969 Tax Reform Act. To the con-

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[5] There can be no dispute that the suggestion which the Congress turned down was one which would *require all* utilities to use straight-line depreciation:

Senate Finance Committee Report:

"• • • On the other hand, a rule *requiring* all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. U.S. Code Cong. & Ad. News, Vol. 2, 1969, p. 2204." (Emphasis supplied.)

House Finance Committee Report:

"Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities *no longer be permitted* to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases. U.S. Code Cong. & Ad. News, Vol. 2, 1969, p. 1783" (Emphasis supplied).

trary, as is manifest from Opinion 578 and 578-A here involved, Texas Gas was *permitted* to change to liberalized depreciation with normalization (not straight-line depreciation) because the Commission, in the exercise of its discretion, found that in the circumstances involved, such a change would serve the public interest. Since such ruling may not be applicable in different circumstances or binding upon the other administrative agencies regulating the other utilities subject to the provisions of Section 441, the Commission's action in the instant cause is patently not comparable to the rejected suggestion.

Respectfully submitted,

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Nos. 486 and 488

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MICHAEL RODAK, JR.

IN THE

Supreme Court of the United States

October Term, 1972

Supreme Court, U.S.
FILED
FEB 26 1973
MICHAEL RODAK, JR., CLERK

No. 486

FEDERAL POWER COMMISSION,

Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 488

TEXAS GAS TRANSMISSION CORPORATION,

Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE* AND BRIEF FOR *AMICI CURIAE*,

Jersey Central Power & Light Company
Metropolitan Edison Company
New Jersey Power & Light Company
Pennsylvania Electric Company

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February 1, 1973

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IN THE

Supreme Court of the United States

October Term, 1972

No. 486

FEDERAL POWER COMMISSION,

Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 488

TEXAS GAS TRANSMISSION CORPORATION,

Petitioner,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ION FOR LEAVE TO FILE BRIEF *AMICI CURIAE*

rsey Central Power & Light Company, Metropolitan
n Company, New Jersey Power & Light Company,
ylvania Electric Company ("Movants") hereby re-
fully move for leave to file the annexed brief amici
e in this proceeding.*

---

*vants file this Motion since their request for consent for the
of the annexed brief was granted by Petitioners, Federal
Commission and Texas Gas Transmission Corporation, but
by Memphis Light, Gas and Water Division and Public
Commission of the State of New York.

Movants are four electric utilities which, pursuant to the provisions of the Federal Power Act, are subject to the jurisdiction of the Federal Power Commission (FPC). Movants provide electric energy to both retail and wholesale customers in portions of the states of New Jersey and Pennsylvania. All of the common stock of each of the Movants is owned by General Public Utilities Corporation, a holding company subject to the jurisdiction of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935.

The interest of the Movants in these proceedings stems from the jurisdiction which the FPC at the wholesale level and state commissions at the retail level have over their electric rates. Although the decision of the Court below deals only with the impact of the Tax Reform Act of 1969 on rate-making by the FPC under the Natural Gas Act, the interpretation by the Court below of subsection 167(l) of the Internal Revenue Code would also apparently deny (except in extraordinary circumstances) to all rate regulatory agencies discretion to permit a change in income tax depreciation of pre-1970 property for ratemaking purposes from liberalized depreciation with flow-through to straight-line depreciation or liberalized depreciation with normalization. The Movants believe that the interpretation of the Court below was incorrect and if not reversed will have a significantly adverse impact upon their earning and financing.

No electric utility company is a party to these proceedings and Movants do not believe that any of the parties to these proceedings can properly be expected to demonstrate to this Court the effect which the decision of the Court below, if not reversed, will have upon electric utilities.

Accordingly, Movants respectfully ask this Court for permission to file the annexed brief.

February 1, 1973

Respectfully submitted,

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Attorney for
Jersey Central Power & Light Company
Metropolitan Edison Company
New Jersey Power & Light Company
Pennsylvania Electric Company

In the

Supreme Court of the United States

October Term, 1972

No. 486

Federal Power Commission,

Petitioner,

v.

Memphis Light, Gas and Water Division, *et al.*

No. 488

Texas Gas Transmission Corporation,

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v.

Memphis Light, Gas and Water Division, *et al.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR *AMICI CURIAE*,

Jersey Central Power & Light Company
Metropolitan Edison Company
New Jersey Power & Light Company
Pennsylvania Electric Company

Question Presented

Whether Congress intended by subsection (l) of Section 167 of the Internal Revenue Code (added by Section 441

of the Tax Reform Act of 1969) to withdraw from the Federal Power Commission (and other federal and state rate regulatory agencies) the authority and discretion to permit a utility to change, for rate-making purposes, its method of tax depreciation of property acquired prior to 1970 from liberalized depreciation with flow-through to either straight-line depreciation or liberalized depreciation with normalization.

The Interest of the *Amici Curiae*

The *amici curiae* are electric utility companies whose rates for retail electric service are regulated by state commissions under the state laws establishing such commissions and whose rates for wholesale for resale electric service are regulated by the Federal Power Commission (FPC) under the Federal Power Act, 16 U.S.C. 791a *et seq.* Prior to the enactment of the Tax Reform Act of 1969, such rate regulatory agencies had exercised their discretion to require that the allowable electric service rates of the *amici curiae* be determined on the basis of liberalized tax depreciation with flow-through. As a result of the enactment of the Tax Reform Act of 1969, the *amici curiae* are seeking to have their electric service rates determined on the basis of liberalized tax depreciation with normalization for *all* their depreciable property.

In form the decision of the Court below deals only with the impact of the Tax Reform Act of 1969 on rate-making by the FPC under the Natural Gas Act, 15 U.S.C. 717-717w. However, the interpretation by the Court below of subsection 167(l) of the Internal Revenue Code would also apparently deny (except in extraordinary circumstances) to all rate regulatory agencies having jurisdiction over utilities supplying retail or wholesale electric, gas, water or

steam services *discretion* to permit a change in income tax depreciation of pre-1970 property for rate-making purposes from liberalized depreciation with flow-through to either straight-line depreciation or liberalized depreciation with normalization. The *amici curiae* believe that the Court below did not correctly interpret subsection 167(l). They, therefore, urge that the decision of the Court below be reversed.

Statement

In order to avoid duplication, the *amici curiae* hereby adopt the Statement in the brief for Petitioner, Texas Gas Transmission Corporation (Texas Gas).

ARGUMENT

I.

The provisions of subsection 167(l) of the Internal Revenue Code do not, by their terms, restrict the exercise of Commission *discretion* to permit a utility to change *from* liberalized tax depreciation with flow-through with respect to pre-1970 property.

This case principally involves two of the five subdivisions of Subsection 167(l), namely,

I. Subdivision (l)(1) dealing with public utility property acquired before 1970 ("pre-1970 property"); and

II. Subdivision (l)(4) providing certain specific rules with effect to the flow-through method.

Subdivision (l)(2) deals with public utility property acquired after 1969 ("post-1969 property"); while this Subdivision is also involved in the Commission's order here under re-

view, since the bulk of the property involved is pre-1970 property and the same rule applies to the post-1969 non-expansion property, we have cast our analysis and argument in terms of the pre-1970 property for simplicity. Subdivision (l)(3) contains definitions applicable to Subdivisions (l)(1) and (l)(2). Subdivision (l)(5) deals with reorganization and similar matters.

Subdivision (l)(1) provides, in substance, that, for Federal income tax purposes, *in the case of pre-1970 property*, a utility covered by Subdivision (l) (an "affected utility") *may*, subject to certain conditions:

A. Use straight-line depreciation (Method 1); *or*

B. Use liberalized depreciation with normalization (Method 2); *or*

C. Use liberalized depreciation with flow-through (Method 3).

See Section 167(l)(1)(A)(i), (ii) and (B)(i).

All affected utilities may use Method 1.

Utilities on liberalized depreciation in 1968 *may, in the alternative*, use Method 2.

Utilities on liberalized depreciation with flow-through in July 1969 *may, in the alternative*, use Method 3.

As a result, *with respect to pre-1970 property*, (i) affected utilities which used straight-line depreciation in 1968 have to remain on that method and cannot switch to another method; and (ii) affected utilities which used liberalized depreciation with normalization in July 1969 cannot switch to liberalized depreciation with flow-through.

The restrictions in subdivision (l)(1) on changes in the method of tax depreciation of pre-1970 property are restrictions on change in one direction, but not in the other.

By denying to affected utilities with respect to such property (a) the right to use liberalized tax depreciation if they were not using it in 1968 and (b) the right to use liberalized tax depreciation with flow-through if they were not using it in July 1969, Congress protected the federal government against an increase in the loss of tax revenues which had already reached the level of $1.5 to $2.0 billion annually. Moreover, recognizing that income taxes are part of the allowable costs of service for rate regulatory purposes as established by this court in *Galveston Electric Company* v. *City of Galveston*, 258 U.S. 388, 399 (1922), Congress also relieved affected utilities from pressure by rate regulatory agencies to change their methods of tax depreciation of pre-1970 property from Method 1 (straight line) to Method 2 (liberalized depreciation with normalization) or Method 3 (liberalized depreciation with flow-through), or from Method 2 to Method 3.

On the other hand, there is nothing in the express terms of subdivision (1)(1) which provides, or even suggests, that a utility is restricted in changing *from* liberalized depreciation with flow-through to either liberalized depreciation with normalization or to straight-line depreciation, or from liberalized depreciation with normalization to straight-line depreciation. To the contrary, in view of this omission, it is apparent that Congress did not intend to modify past practices with regard to such changes, including the opportunity for review and approval or disapproval of such changes by the appropriate regulatory agency.[1]

[1] If a utility does change from Method 3 to Method 1 or 2 with respect to pre-1970 property and its rate regulatory agency refuses in its discretion to recognize that change, the economic consequences to the utility and its consumers and investors will be severe. For this reason, a utility is unlikely to make such a change unless it believes that its rate regulatory agency will recognize the change.

Paragraph (A) of Subdivision (l)(4) grants to a utility the *right* to elect, within 180 days after the enactment of the Tax Reform Act of 1969, to shift from liberalized tax depreciation with flow-through for post-1969 property representing growth in capacity (usually referred to as "expansion property"). The consequence of this election is to *require* its rate regulatory agency to change its rate-making policies with *respect to expansion property;* i.e., an electric utility may *require* the rate-making agency to fix rates on straight-line tax depreciation for expansion property unless the agency permits it to use liberalized tax depreciation with normalization with respect to that property.

Since paragraph (l)(4)(A) is limited to post-1969 expansion property, it does not accord a utility the right to make an election which is binding on its rate regulatory agencies with respect to either pre-1970 property or non-expansion post-1969 property. But the fact that the utility cannot *force* a change on its rate regulatory agency is no warrant for denying to the rate regulatory agency the power, *in its own discretion,* to permit the utility to make the change, if the agency finds the change justified.

The Senate Finance Committee version of the bill that became the Tax Reform Act of 1969 had granted affected utilities an election *forcing* their rate regulatory bodies to fix rates on the basis of either straight-line tax depreciation or liberalized tax depreciation with normalization for *all property.* The Conference Committee version of the Bill that was enacted (i.e., paragraph (l)(4)(A)) limited the utility's election to post-1969 expansion property. The Court below reads this change as a demonstration of Congressional intent to preclude a rate regulatory agency as a matter of *discretion* from changing from liberalized depreciation with flow-through for pre-1970 property. If Congress had intended this result, surely it would have

made it explicit. Nothing in the legislative history indicates that this denial of discretion may be fairly implied from the words of the statute. Explicit language denying a rate regulatory agency the right to permit a utility to change to liberalized depreciation with normalization with respect to its pre-1970 property would logically have appeared in paragraph (1)(4)(B). But that paragraph merely provides that, for purposes of paragraph (1)(1)(B), a utility that had pending on August 1, 1969 a timely application to change to flow-through with respect to pre-1970 property will be treated under certain conditions as if it were using flow-through in July 1969.

Stated in another way, subsection (1) *expressly* prohibits a utility from changing *to* liberalized depreciation with flow-through for *any property* if the utility was not employing flow-through in July 1969. Subsection (1) also *expressly* prohibits a utility from using liberalized depreciation with flow-through for *expansion property* if the utility made the election to that effect permitted by paragraph (1)(4)(A). But nothing in subsection (1) expressly prohibits a utility from changing *to* straight-line tax depreciation or to liberalized tax depreciation with normalization, even though it would have been entitled to use liberalized tax depreciation with flow-through if it wished. Similarly, nothing in subsection (1) expressly requires a rate regulatory agency to refuse recognition to such a change by the utility if the regulatory agency finds such a change consistent with the regulatory statutes which it is administering.

The conclusion of the Court below that Congress intended this result has no support in the express terms of the actual legislation that was adopted and is based solely on an unfounded implication that the Court below drew from the changes in the Bill during the course of legislative con-

sideration. As discussed in Point III of this brief, this legislative history supports the conclusion that a regulatory agency's *discretion* to permit a change *from* flow-through was not affected by the Tax Reform Act of 1969.

II.

The consequences of the holding of the Court below are so far-reaching that this holding should be reversed by this Court unless clearly compelled by subsection 167(l).

The Court below correctly held that Congress could limit the discretion of rate regulatory agencies by legislative means other than amendments of the rate regulatory statutes. Congress had previously done so, in the case of federal rate regulatory agencies and the 3% investment tax credit, by the Revenue Act of 1964,[2] and it subsequently did so, in the case of state and federal rate regulatory agencies, by the Economic Stabilization Act of 1970,[3] but, at a minimum, it may be reasonably expected that Congress would be explicit when it intends to exercise such powers.

In the case of subsection (l), Congress clearly recognized that it was limiting the discretion of rate regulatory agencies (state and federal) by precluding them from thereafter fixing rates on a liberalized depreciation with flow-through basis for pre-1970 property if the utility was not using flow-through on July 1969 with respect to that property, and for expansion property, even though the utility had been using flow-through, if the utility made the timely election provided for in paragraph (l)(4)(A).[4] Indeed, the whole of subsection (l) is based upon the rate-making con-

[2] Revenue Act of 1964, Section 203(e); P.L. 88-272, 78 Stat. 19 (1964).

[3] 12 U.S.C. 1904 et seq. 84 Stat. 796, 85 Stat. 743.

[4] S. Rep. No. 552, 91st Cong., 1st Sess. 173-174 (1969).

sequences of limiting the availability of liberalized tax depreciation deductions. But, if the Court below is correct, then Congress was also restricting the discretion of rate regulatory agencies (state and federal) by precluding them from thereafter fixing rates on any basis other than liberalized depreciation with flow-through for non-expansion property for any utility that was using flow-through in July 1969. A careful study of the opinion of the Court below demonstrates, however, that nowhere did the Court below cite any part of subsection (l) or its legislative history to demonstrate that Congress expressly intended this result; nor could it, since the legislative history clearly established the contrary.

Ever since the *Hope* case,[5] if not before, this Court has recognized the necessity of according to rate regulatory agencies broad discretion absent express statutory limitations thereon—a view reaffirmed as recently as the last session of this Court.[6] Yet, in this case, the Court below would reach the contrary result for all rate regulatory agencies, state and federal, based solely upon an implication—an unfounded implication as demonstrated below—from a change in the Bill made during the course of Congressional consideration with respect to the scope of an election made available to utilities.

Both Houses of Congress had recognized, during their consideration of the Bill, that about half of the rate regulatory agencies had required flow-through for any utility that employed liberalized tax depreciation and that some of those rate regulatory agencies had fixed rates on the basis of imputing liberalized tax depreciation with flow-through even if the utility actually employed straight-line

[5] *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[6] *F.P.C. v. Louisiana Power and Light Co.*, 406 U.S. 621 (1972).

tax depreciation.[7] The rate regulatory agencies requiring flow-through included such important state agencies as the California, New Jersey, New York and Pennsylvania commissions as well as the FPC. To deny to these numerous agencies with broad public responsibilities the opportunity—in their discretion—to modify their position, if changing conditions warrant this or if the premise on which their prior position rested is no longer valid, should require the clearest of express Congressional mandates.

III.

The legislative history of subsection 167(l) does not support the holding of the Court below.

The FPC had followed a tortuous path in connection with liberalized tax depreciation and the Natural Gas Act. In 1956,[8] and again in 1959[9] the FPC permitted liberalized tax depreciation with normalization, but it neither reduced rate base nor accorded separate capitalization treatment to the accumulated normalization credits. This original position of the FPC was affirmed by the Courts of Appeals as being within the FPC's administrative discretion and this Court denied certiorari.[10] In 1961, while it continued to permit liberalized tax depreciation with normalization, the FPC modified its prior position by treating the accumulated normalization credits as a separate component of capitalization entitled to a return of only 1.5% per year,

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[7] H. Rep. No. 413, 91st Cong. 1st Sess. (1969) at 131-132; S. Rep. No. 552, 91st Cong. 1st Sess. (1969), at 171-172.

[8] *Amere Gas Utilities Co.*, 15 FPC 760, 15 PUR 3rd 339 (1956).

[9] *El Paso Natural Gas Co.*, 22 FPC 260, 29 PUR 3rd 469 (1959).

[10] *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (5th Cir. 1960), (reversing, on other grounds, *El Paso Natural Gas Co.*, 22 FPC 260, 29 PUR 3rd 469), *cert. denied sub nom.; California* v. *FPC*, 366 U.S. 912 (1961); *City of Lexington* v. *FPC*, 295 F.2d 109 (4th Cir. 1961).

and the FPC's action in changing its prior position was also sustained by the courts.[11] A further change in its position occurred in 1964, when the FPC required a natural gas company using liberalized tax depreciation to also use flow-through[12] and then, in 1966, the FPC decided to impute liberalized tax depreciation with flow-through to a company which was then using straight-line tax depreciation but which had been using liberalized tax depreciation with normalization until the decision in the *Alabama-Tennessee* case.[13] In each case, the court's affirmance of the FPC position was based upon the broad administrative discretion accorded to rate regulatory agencies. The following comment from the Court of Appeals in its *Alabama-Tennessee* opinion is particularly pertinent:

> "• • • The Commission must, of course, concern itself with the possibility of having misread the future and with the future's taking a turn without benefit of advice from the Commission. All things change. But we should expect the agency policy to be sufficiently flexible to attempt to change with changing times. Sufficient unto the day is the evil thereof."[14]

The only conclusion that Congress could have drawn from this zig-zag series of interpretations by the FPC with Court approval (and the repeated refusals by this Court

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[11] *Northern Natural Gas Co.*, 25 FPC 431, 38 PUR 3rd 149 (1961); *Panhandle Eastern Pipe Line Company* v. *FPC*, 316 F.2d 659 (D.C. Cir. 1963).

[12] *Alabama-Tennessee Nat. Gas Co.*, 31 FPC 208, 52 PUR 3rd 118, affirmed *Alabama Tennessee Nat. Gas Co.* v. *FPC*, 359 F.2d 318 (5th Cir. 1966), *cert. denied* 385 U.S. 847 (1966).

[13] *Midwestern Gas Transmission Co.*, 36 FPC 61, 64 PUR 3rd 433 (1966), affirmed *Midwestern Gas Transmission Co.* v. *FPC*, 388 F.2d 444 (7th Cir. 1968), *cert. denied*, 392 U.S. 928 (1968).

[14] *Alabama-Tennessee Natural Gas Co.* v. *FPC*, 359 F.2d 318, (5th Cir. 1966).

to intervene) was that neither the Natural Gas Act nor the Internal Revenue Code mandated any particular rate-making treatment of liberalized depreciation and that the FPC had broad discretion with respect thereto.

One of the early suggestions with respect to this subject made to Congress while the Tax Reform Act of 1969 was being developed was the suggestion of FPC that Congress completely withdraw from utilities the right to use liberalized depreciation.[15] Neither the House Committee nor the Senate Committee adopted the FPC's recommendation which would have adversely affected all utilities that were not at the time using straight-line tax depreciation, until they obtained offsetting rate increases. Instead, the House Committee "determined in general to 'freeze' the current situation" [16] insofar as the existing property of affected utilities is concerned. What was the "freeze" upon which the House Committee thus determined with respect to existing property? It was (i) to deny liberalized tax depreciation in the future to those utilities that were not using it in 1968 and (ii) to deny liberalized tax depreciation to utilities that were using it in July 1969 with normalization unless they continued to use normalization. It was a "freeze" *against movement toward* flow-through. It expressly did not "freeze" the utilities that had been using flow-through into continued use of flow-through; on the contrary, the House Committee expressly recognized that the appropriate regulatory agency could permit a change *from* flow-through[17] and the Court below held that, if the House version had been enacted, the FPC and Texas Gas position would have been clearly justified.

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[15] H. Rep. No. 413, 91st Cong. 1st Sess. (1969) at 132.

[16] *Id.*, at 132-133.

[17] *Id.*, at 133.

The Senate Committee version essentially followed the House version except in one respect. Under the House version, a utility that had been using liberalised depreciation with flow-through could not *force* its regulatory agency to recognise a change away from flow-through, but the agency had discretion to permit such a change. Under the Senate version, such a flow-through utility was given an additional, absolute right, with or without regulatory agency permission, to shift to straight-line depreciation or—with regulatory agency permission—to shift to liberalised depreciation with normalization with respect to both new and existing property.[18] The Senate Committee characterised its action as follows:

> "Accordingly, the Committee agrees with the House that it is appropriate to in general 'freeze' the current situation regarding methods of depreciation * * *."[19]

Once again the only "freeze" was *against* a change *to* flow-through; under the Senate version, the utility could *require* its regulatory agency to accept a change *from* flow-through, but, under both the House and Senate versions, a regulatory agency could *permit* a change *from* flow-through with respect to property as to which the election was not available or exercised within 180 days of the enactment of the Tax Reform Act of 1969. It was in this light that the Senate Committee Report stated:

> "Both the House bill, and the [Senate] committee amendments provide that in the case of existing property the following rules are to apply:
>
> * * *
>
> "(3) If the taxpayer is taking accelerated depreciation and flowing though to its customers the benefits of

[18] S. Rep. No. 552, 91st Cong. 1st Sess. (1969) at 173.

[19] *Id.*, at 172.

the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property." [20]

The Senate Committee amendments, which were adopted by the Senate, made no change in this *general* rule established by both the House and the Senate versions. Those amendments did not, in this respect, even deal with what became subsection 167(l)(1). Instead, such amendments added a *special* rule—one to be invoked by an election made within 180 days by a utility that had been on flow-through but wished to change from flow-through and to impose that change on its regulatory agency.

It was this *special* rule first adopted by the Senate, and not the general rules that had been agreed to by both the House and the Senate, that was the subject of the Conference Committee compromise. The Conference Committee also did not modify, in this respect, what became subsection 167(l)(1); instead, it modified the provision that became subsection 167(l)(4) so as to limit to expansion property the election that a utility could make as of *right* without obtaining its regulatory agency's consent.[21] It is in this context that the Conference Committee Report stated:

"The conference substitute * * * follows the Senate amendment except that * * * the 180-day election (item (d), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right[22] to change over from the

[20] *Id.*, at 172-73.

[21] Conf. Rep. No. 782, 91st Cong. 1st Sess. (1969) at 312-313.

[22] Obviously the *right* referred to the Conference Committee is the right of the utility, exercisable by its election and binding upon its regulatory agency whether or not the latter consented.

flow-through method is to be available only to the extent the new property increases the productive or operational capacity of the company." [33]

It is clear that the error made by the Court below in its analysis of the legislative history stems essentially from its failure to distinguish between (a) "any *power the regulatory agency* might have to require the taxpayer to flow-through" [34] with respect to existing property if the taxpayer was previously using flow-through and (b) the *right of the taxpayer* to make an election, binding upon its regulatory agency, to change from flow-through with respect to expansion property.[35] It was only the right of the taxpayer, first granted by the Senate Committee amendment, that was the subject of the Conference Committee modification so that thereafter the *taxpayer* had no *right* to make an election with respect to existing property. But none of this affected the *power* of the *regulatory agency* to require the continued use (by imputing it for rate-making purposes if it were not in fact used) of flow-through for existing property if the taxpayer had previously used it, or to permit a change therefrom pursuant to the third *general* rule of both the House and the Senate committee reports.

In its original opinion, and even more in its opinion on rehearing, the Court below laid stress on the Congressional statements of the intent "to freeze" generally tax depreciation accounting for utilities. But since the "freeze" language appears in both the House and Senate Committee reports, in respect of both of which the Court below ex-

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[33] Conf. Rep. No. 782, 91st Cong. 1st Sess. (1969) at 313.

[34] General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (3 December 1970) at 151.

[35] *Id.*, at 152.

pressly recognized there was clear provision for a change of a company *from* flow-through with respect to existing property, this "freeze" language cannot sustain the heavy burden that the Court below would place upon it.

IV.

The FPC's action in permitting Texas Gas to shift from flow through to normalization with respect to non-expansion property represented an economically sound exercise of administrative discretion.

Most utilities employ straight-line depreciation for general financial accounting and rate-making purposes (usually referred to as "book depreciation"). Book depreciation thus usually involves the amortization of the net cost of property in approximately equal installments over its estimated service life. If a utility uses liberalized tax depreciation without normalization, it is consuming the income tax deductions represented by the amortization of the cost of its property more rapidly than is reflected in its book depreciation charges, so that the book depreciation reserve does not reflect the fact that an important aspect of the value of property (namely, its income tax-reduction quality) has been thus consumed. It is the function of normalization to recognize and make provision for that fact by recording a "normalizing" charge representing the consumption of the income tax deductions that would be associated with future periods if liberalized depreciation were not employed. Ever since 1958, the accounting profession has required normalization in respect of the use of liberalized depreciation by non-regulated companies.[26] In the case of regulated com-

[26] Research Bulletin No. 44 (Revised), Committee on Accounting Procedure, American Institute of Certified Public Accountants (1958).

panies, the accounting profession recognized that the rate regulatory agency's control of the rate-making process also included control of the time when costs would be recognized and revenues allowed in respect thereof, and that the profession could not, therefore, require normalization for regulated utilities if the rate regulatory agency required flow-through.[37]

Initially, as noted earlier, the FPC permitted normalization by natural gas companies. But, in 1964 in *Alabama-Tennessee Nat. Gas. Co.*,[38] it required flow-through. The basis for this requirement was the FPC's conclusion that, for natural gas companies with stable or growing utility plant, under liberalized depreciation the larger tax depreciation deductions associated with new additions to plant would more than offset the reductions in depreciation deductions on older items of plant.[39] This premise of the FPC's conclusion in *Alabama-Tennessee* was that there would be a continuing infusion of larger depreciation deductions resulting from use of liberalized depreciation in respect of new plant additions, so that the utility and rate regulatory agency need not be concerned by the continuing smaller or non-existent deductions in respect of old plant. This premise is completely undercut, however, if a natural gas company exercises its right to switch *from* flow-through in respect of expansion property, as Congress expressly

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[37] *Id.*, at paragraph 8. See also Addendum to Opinion No. 2 of the Accounting Principles Board, American Institute of Certified Public Accountants (1962).

[38] 31 FPC 208, 52 PUR 3d 118 (1964), affirmed 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847 (1966).

[39] In retrospect, it is unfortunate that the accounting profession and the FPC have discussed this matter in terms of liability for the payment of taxes rather than in terms of the consumption of that aspect of the value of plant represented by its income tax-reductive quality via depreciation deductions.

permitted by section 167(l)(4)(A). Texas Gas took precisely this action.

Under the circumstances, the FPC could no longer logically insist that Texas Gas employ flow-through for its pre-1970 property. There would clearly be a quickly developing trend of reduced tax depreciation deductions (and, therefore, higher income taxes) and present consumers would be benefitting by the use of tax depreciation deductions properly associated with service to future consumers. By contrast, by allowing normalization, the FPC would be permitting Texas Gas to recognize currently the consumption of income tax deductibility so that each successive generation of its customers would have the benefit of the tax depreciation deductions associated with service to it—but no more.

The increase in rates to present customers resulting from the current normalizing change has the dual effect of (i) providing more cash currently and thereby reducing the amount of new capital to be raised currently and (ii) reducing rate base and, therefore, future charges to customers. In addition, so long as the reserve created by the normalizing charge is deducted from rate base—and this was required by the FPC in this case and as long ago as 1961,[20] normalization of the reduction in income taxes currently payable by reason of liberalized tax depreciation does not increase the earnings available for stockholders.

In other respects, such as the establishment of area rates for natural gas producers and rate differentials in order to stimulate the commitment of additional supplies of natural gas to interstate service, the courts have been willing to recognize the necessity for according wide dis-

[20] *Northern Natural Gas Co.*, 25 FPC 431, 38 PUR 3rd 149 (1961); *Panhandle Eastern Pipe Line Company*, 25 FPC 550, 38 PUR 3rd 307 (1961).

cretion to the FPC. In this instance, with the implications not only for the FPC but also for other rate regulatory agencies, this Court should affirm the action of the FPC as a sound exercise of its administrative discretion.

CONCLUSION

The decision of the Court of Appeals with respect to liberalized tax depreciation in respect of *pre*-1970 and *post* 1969 non-expansion property should be reversed and the decision of the FPC should be affirmed without further proceedings.

Respectfully submitted,

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February 1, 1973

FILE COPY

FEB 1 1973

MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

Supreme Court, U.S.
FILED
FEB 26 1972
MICHAEL RODAK, JR., CLERK

OCTOBER TERM 1972

Nos. 72-486 AND 72-488

FEDERAL POWER COMMISSION,
Petitioner

v.

MEMPHIS LIGHT, GAS & WATER DIVISION, et al,
Respondents

TEXAS GAS TRANSMISSION CORPORATION
Petitioner

v.

MEMPHIS LIGHT, GAS & WATER DIVISION, et al,
Respondents

Motion For Leave To File Amicus Curiae Brief and Brief Of The Independent Natural Gas Association of America, Amicus Curiae, In Support of Petitioners

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February 1, 1973

FIDELITY PRINTING COMPANY, INC., HOUSTON

In The

Supreme Court of the United States

October Term 1972

Nos. 72-486 and 72-488

Federal Power Commission,
Petitioner

v.

Memphis Light, Gas & Water Division, et al,
Respondents

Texas Gas Transmission Corporation
Petitioner

v.

Memphis Light, Gas & Water Division, et al,
Respondents

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF THE INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA IN SUPPORT OF PETITIONERS

The Independent Natural Gas Association of America ("INGAA") respectfully moves for leave to file the attached brief *amicus curiae* in this case. As indicated by letters contemporaneously filed herewith, INGAA has obtained consent of petitioners, Texas Gas Transmission Corporation and Federal Power Commission, and respondent, The Public Service Commission for the State of New York. Respondent, Memphis Light, Gas and Water Division has declined to consent.

INGAA is a non-profit association. Its members include most of the natural gas transmission companies subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act, 15 U.S.C. § 717, et seq. Their operations account for more than 90% of the gas transported and sold annually in interstate commerce in the United States.

INGAA has participated in the past as an intervenor or *amicus curiae* before this court and various United States Courts of Appeals. It undertakes to participate in cases which directly and significantly affect the interests and operations of its membership and which have substantial industry-wide consequences. This is such a case.

With few exceptions, INGAA's pipeline members have been required, as a result of the Commission's decisions in the *Alabama-Tennessee* and *Midwestern* cases,[1] to base their rates on the use of liberalized depreciation with flow-through rather than on normalization or straight line depreciation. All except two have made the election provided for in § 441(a) of the Tax Reform Act of 1969, with respect to post-1969 expansion property.

The Commission has acted in only one case since the issuance of Order 404 and the Opinions 578 and 578-A in the matter of *Texas Gas Transmission Corporation.* In a decision involving Transwestern Pipeline Company, it found following an evidentiary hearing that as a result of changed circumstances, including the intercession of the 1969 Tax Reform Act, the rationale of *Alabama-Tennessee* did not apply to Transwestern. It concluded *inter alia* that the

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[1] *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 (1964) aff'd. sub nom., *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F.2d 318 (5th Cir. 1966), cert. den. 385 U.S. 847; *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), aff'd., *Midwestern Gas Transmission Co.* v. *Federal Power Commission*, 388 F.2d 444 (7th Cir. 1968), cert. den. 392 U.S. 928.

continuation of flow-through would discriminate against Transwestern's future ratepayers and accordingly permitted a return to normalization. *Transwestern Pipeline Company*, Opinions 597 and 597-A, 45 FPC 1170, 46 FPC 379 (1971). This case is pending on appeal before the Court of Appeals for the District of Columbia Circuit sub nom., *The People of the State of California, et al* v. *Federal Power Commission*, No. 71-1830.[2]

Other INGAA members have requests pending before the Federal Power Commission for permission to resume normalization accounting with respect to pre-1970 property and post-1960 non-expansion property. See e.g. *Texas Eastern Transmission Corporation* FPC Docket No. RP 70-29 *et al*, Examiner's Decision issued December 9, 1971. Inasmuch as their interests, which are not represented by Texas Gas or the Federal Power Commission, can be directly affected by the Court's decision in this case, it is considered appropriate to submit this *amicus curiae* brief.

INGAA therefore respectfully requests leave to file such brief *amicus curiae* in support of petitioners.

Respectfully submitted,

/s/ JEROME J. McGRATH

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February 1, 1973

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[2] By order issued January 23, 1973 the Court of Appeals postponed oral argument which had been scheduled for January 29, 1973 and stayed further proceedings pending action of this court in the *Texas Gas* case.

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AMICUS CURIAE BRIEF OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

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February 1, 1973

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IN THE

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Petitioner

v.

MEMPHIS LIGHT, GAS & WATER DIVISION, et al,
Respondents

AMICUS CURIAE BRIEF OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA

The Independent Natural Gas Association of America ("INGAA") respectfully submits this brief as *amicus curiae* in support of Petitioners, Federal Power Commission and Texas Gas Transmission Corporation. It is INGAA's basic position that the Court below misconstrued § 441(a) of the Tax Reform Act of 1969 and that its decision reversing the Federal Power Commission in *Texas Gas Transmission Corporation*, Opinions 578 and 578-A should be reversed. INGAA's interest is set forth in its Motion for Leave to File Amicus Curiae Brief.

ARGUMENT

Background

Liberalized or accelerated depreciation was first permitted by the Internal Revenue Code of 1954. Thereafter, finding that the use of liberalized depreciation would result in a "deferral" of taxes, the Commission adopted a policy of permitting regulated utilities to "normalize" taxes in computing cost of service for rate purposes. This being regarded as a matter within the Commission's special expertise "as a trier of facts", its determination was uniformly upheld by the courts. *Cities of Lexington, Ky. et al* v. *Federal Power Commission,* 295 F.2d 109, 113 (4th Cir. 1961); *El Paso Natural Gas Company* v. *Federal Power Commission,* 281 F.2d 567 (5th Cir. 1960), cert. den. 366 U.S. 912.

Subsequently, the Commission in *Alabama-Tennessee Natural Gas Company* 31 FPC 208 (1964) reversed its position and found that continuing pipeline expansion could reasonably be anticipated for the foreseeable future and that, consequently, depreciation charges on future plant additions under liberalized depreciation rules would offset the decline in depreciation on existing plant. It concluded, therefore, that the use of liberalized depreciation resulted in a tax saving for the utility rather than merely a tax deferral. Based on this finding, the Commission required the pipelines to compute their cost of service on actual taxes. rather than normalized taxes and to "flow-through" the benefits of liberalized depreciation in the form of reduced rates.[2]

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[1] The terms "flow-through" and "normalization" and their respective tax and rate consequences are described and discussed in detail in *City of Chicago* v. *FPC,* 385 F.2d 629 (D.C. Cir. 1967), cert. den. 390 U.S. 945; *Alabama-Tennessee Natural Gas Co.* v. *FPC,* 359 F.2d 318, cert. den. 385 U.S. 847; *Panhandle Eastern Pipeline Co.* v. *FPC,* 316 F.2d 659 (D.C. Cir. 1963),

Significantly, the Commission did not reject the concept of normalization. It held merely that the facts and circumstances then existing "make it apparent that normalization is premature." 31 F.P.C. at 216.

Again, the Commission was affirmed by the courts, the matter being regarded as one involving regulatory discretion. *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F.2d 318 (5th Cir. 1966) cert. den. 385 U.S. 847; *City of Chicago, et al* v. *Federal Power Commission*, 385 F.2d 629 (D.C. Cir. 1967), cert. den. 390 U.S. 945. In affirming, the Fifth Circuit characterized the Commission's finding that liberalized depreciation would result in a tax saving as "fundamental" and "critical" and held that while it necessarily constituted merely "a fair guess as to future conditions," it was adequately supported. *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission, supra*, 359 F.2d at 318, 323, 332.

In *Midwestern Gas Transmission Company* 36 F.P.C. 61 (1966), which followed the affirmance of *Alabama-Tennessee*, the Commission imputed the use of flow-through accounting in determining the rates of Midwestern although that company had elected to utilize straight-line depreciation. The Commission based its decision on a finding of abuse of management discretion in the selection of depreciation methods. It was again affirmed, *Midwestern Gas Transmission Co.* v. *Federal Power Commission*, 388 F.2d 444 (7th Cir., 1968) cert. den. 392 U.S. 928, the Court concluding that the record supported the Commission in its "favorable estimates of future plant growth." 388 F.2d at 447.

Section 441(a) of the 1969 Act represents congressional

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cert. den. 375 U.S. 881; and *Cities of Lexington, Ky. et al.* v. *FPC*, 295 F.2d 109 (4th Cir. 1961). This is not a subject which is new to the Commission, the courts, or Congress.

response to *Alabama-Tennessee* and *Midwestern* and to similar decisions by other regulatory agencies. It provides the mechanics for eliminating the premise on which the flow-through requirement was based, namely that depreciation deductions on future plant under liberalized depreciation rules would *in fact* offset the decline in deductions on existing plant and thus produce a tax saving to the utility. For the utility making the election provided for in § 441(a), this would not be the case.[3] Contrary to the holding of the Court below, the amendment contemplated the discontinuation of flow-through and the use of normalization accounting with agency approval when normalization was no longer "premature".

THE HOLDING OF THE COURT BELOW

The lower court erroneously held, INGAA submits, that the 1969 Act compels the utilities, which were basing their rates on flow-through at the time the Act was adopted, to continue to do so with respect to existing property without regard to changed circumstances and without regard to the effect flow-through might have on such utilities, on the rates which they charge or on the customers which they serve. The decision of the Federal Power Commission in Opinions 578 and 578-A permitting Texas Gas Transmission Corporation to change from flow-through accounting to normalization with respect to existing property was said to produce an effect "precisely contrary to that envisioned by Congress."

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[3] In addition to changes in the tax laws other circumstances have changed significantly since 1964 when *Alabama-Tennessee* was decided. Then the Commission anticipated adequate gas reserves to support pipeline expansion at least through 1980 and saw no significant decline in reserves prior to the twenty-first century. See *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission, supra*, 359 F.2d at 338; *Midwestern Gas Transmission Co.* v. *Federal Power Commission, supra*, 388 F.2d at 447. The current shortage of natural gas is a matter of judicial notice.

462 F.2d at 863.[3] Reversing the Commission, the Court states:

> ". . . since Texas Gas has been employing liberalized depreciation with flow-through, it is *specifically prohibited*, under the final version of the bill from abandoning such depreciation. . . ." 462 F.2d at 863.[4]

This simply is not so.

THE AMENDMENTS ADOPTED BY THE 1969 ACT

Their Purpose and Purport

The principal thrust of the 1969 amendments relating to liberalized depreciation was to prevent prospective tax revenue losses as the result of the regulatory agencies' requiring or imputing flow-through accounting in establishing utility rates and generally to decelerate the trend toward faster methods of depreciation.[5] Following references to these matters, the House Committee Report states:

> "Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion; some estimates indicate that the loss might be considerably closer to

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Cf. Federal Power Commission v. *Louisiana Power & Light Company et al.*, 406 U.S. 621 (1972) in which the Court quoted from an FPC Staff Report which stated: "The emergence of a natural gas shortage during the past two years marks an historic turning point — the end of natural gas industry growth uninhibited by supply considerations." 406 U.S. at p. 626.

[3] For convenience, post-1969 expansion property is referred to as "expansion property." Pre-1970 property and post-1969 non-expansion property is referred to as "existing property."

[4] Emphasis in quotations added unless otherwise indicated.

[5] Such agency action was referred to in the report of the Senate Committee staff as the "[p]roblem." In the House and Senate reports, the discussion of these decisions is set out under the heading "General Reasons for Change." H. Rept. No. 91-413, U.S. Code Cong. and Ad. News, Vol. 2, 1969 p. 1782; S. Rept. No. 91-552, *ibid*, p. 2204.

> $2 billion per year. Your committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow-through is unacceptable at this time." H. Rept. No. 91-413, U.S. Code Cong. and Ad. News, Vol. 2, 1969 p. 1783.

The lower court correctly recognized this problem as a "prime consideration" of Congress. Specifically, it stated:

> "This overall congressional objective to forestall prospective revenue losses, without handicapping the utility industry, was a prime consideration at all stages of the legislation." 462 F.2d at 868.

Unaccountably, however, it failed to read the statute and its legislative history with this objective in mind. A change *from* flow-through to normalization, such as that permitted Texas Gas in Opinions 578 and 578-A, serves to increase rather than decrease tax revenues. The Commission's decision was therefore completely consistent with the stated objective of the Act. It was the *reverse* of this situation, *i.e.*, changes from normalization *to* flow-through and the imputation of flow-through, both of which serve to *reduce* taxes, with which Congress was concerned.

The Limitation on Agency Discretion

Congress clearly undertook by the adoption of § 441(a) to limit agency discretion, but not in the manner held by the court below and certainly not through any arbitrary and immutable "freeze." It approached the problem of agency decision requiring flow-through accounting indirectly by specifying the particular depreciation methods which would constitute "reasonable allowance[s]" under various circumstances, and thus eliminating both *agency* and *management discretion* to employ any other method for tax or rate purposes. The lower court failed to recognize this.

A finding of an abuse of management discretion in the selection of a depreciation method, as in *Midwestern*, is the sole basis for the imputation of flow-through. Thus the designation of particular methods under particular circumstances removes the basis for imputing flow-through and requires the agency to base the utilities' rates on the particular method prescribed by the Act. As an example, agency discretion with respect to pre-1970 property to require flow-through by a utility that is employing liberalized depreciation with normalization is curtailed by § 441(a)(1)(A). That section permits liberalized depreciation *only* if the taxpayer uses a normalization method of accounting. Thus, if the regulatory agency undertakes to require flow-through, the Act provides that the only "reasonable [depreciation] allowance" would be that computed from the use of straight-line depreciation. As straight-line depreciation deductions would constitute the only reasonable allowance, the agency would be required to recognize them in fixing rates. Similarly, with respect to the election provision, if the agency does not permit normalization, the utility is required to utilize straight-line deprecation. As the Senate Committee Report regarding the provision states, under these circumstances "the agency would not be able to impute the use of accelerated depreciation with flow-through". S. Rept. No. 91-522, U.S. Code Cong. and Ad. News, Vol. 2, 1969 p. 2206.

The same is not true, however, with respect to the Act's treatment of the discontinuation of flow-through. Changes from flow-through to normalization do not decrease tax revenues. They increase them. Consequently, they serve the principal objective of the 1969 amendments, and regulatory agency discretion with respect thereto was not curtailed.[6]

THE ELECTION PROVISION

In its construction of the Act, the lower court reads the election provision as the *only means* by which a utility utilizing liberalized depreciation with flow-through could change to normalization. This, it seems to INGAA, is the root of the lower Court's error.

The election provision first appeared in the Senate version of the Act. Pointing to it, the Court states:

> "... the Senate limited (the Commission and Texas Gas can point to no language to the contrary) *all* changes [from flow-through] re both expansion and non-expansion property to a 180-day election." 462 F.2d at 867.

The Court reasons that when the Senate version of the election, which covered all property, was limited in conference to expansion property only, the ability of the regulated utility to discontinue flow-through, *with or without agency consent,* was thereby limited to expansion property. It finds support for this conclusion from references in the various reports of an intent to "freeze" the current situation.

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[6] The comment in the General Explanation quoted by the Court, 462 F.2d at 868, that the related section of the Act does not affect the agency's power "to require the taxpayer to flow through" relates *solely* to the limited situation in which the utility was taking accelerated depreciation and flowing-through as of August 1, 1969. In such cases *only,* the Commission in the exercise of its discretion could require the continuation of flow-through or impute flow-through if the utility undertook to change to straight line other than through utilization of the election procedure. On the other hand, the reports of both Houses clearly established that the Commission, also in the exercise of its discretion, could permit a change from flow-through *to* either straight-line or liberalized depreciation with normalization.

The Court is wrong. The language of the Act itself is contrary to its conclusion. As finally adopted, § 441(a)(1)(B) provides that with respect to pre-1970 public utility property, the taxpayer which had been utilizing a flow-through method of accounting *"may"* use the applicable 1968 method for such property. The Court, however, has read this section of the Act as providing that the taxpayer *"must"* use the applicable 1968 method and continue flow-through without regard to the consequences.

The right of the utility to change from flow-through to normalization with respect to existing property under the Act is further confirmed by the Senate report relating to its version of § 441(a)(1), which was carried forward virtually unchanged into the Act as finally adopted. The report states:

> "Both the House bill and the [Senate] committee amendments provide that in the case of existing property the following rules are to apply:
>
> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.
>
> (2) If the taxpayer is taking accelerated depreciation and is 'normalizing' its deferred taxes, then it must shift to the straight line method unless it continues to normalize as to that property.[7]
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), *unless the appropriate regulatory agency permits a change as to that property.*" (S. Rept. No. 91-552, U.S. Code Cong. and Ad. News, Vol. 2, 1969, p. 2205.

[7] i.e., the regulatory agency cannot *require* flow-through.

Except for the parenthetical phrase, which refers to the election provision and a change of the language in paragraph (3) from "must continue" to "would continue" the Senate Report's explanation is identical with that set forth in the House Report regarding its version of the Act which contained no election provision. The italicized clause indicates Senate intent that in addition to changes available as a matter of right pursuant to the election provision, changes from flow-through to normalization would be permissible with agency approval. Otherwise the clause has no meaning. Thus rather than "specifically prohibit[ing]" the discontinuation of flow-through, as the lower Court held, the Act specifically recognizes that such discontinuation may occur.

The lower Court agreed that under the House version of the Act Texas Gas could have been permitted a change from flow-through to normalization on existing property with agency approval. 462 F.2d at 862. It compares the House bill, however, with the Senate bill, which contains the same provisions and explanation but which added the further right in the utility to elect within 180 days to discontinue flow-through with respect to all property, and concludes that the limitation of the scope of the election to expansion property in the Act as adopted prevents *all other changes,* even though made with agency approval.[8] This simply does not follow.

Nor is the lower court correct in its belief that leaving discretion with the Commission to permit a change from flow-through to normalization expands the election provi-

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[8] The Conference Report states simply that the election provision has been "modified to apply to new [expansion] property and not to replacement property." Conference Report No. 91-782, U.S. Code Cong. and Ad. News, Vol. 2., 1969, p. 2427.

sion to cover "all property". 462 F.2d at 870. The Court has failed to recognize the distinction, which Congress preserved in the Act, between (1) property with respect to which the utility has the right to discontinue flow-through without agency approval (expansion property when the election has been made) and (2) property with respect to which it must obtain agency *permission* to discontinue flow-through (all other property including expansion property when the election has not been made). The fact that the regulatory agencies were required by the final version of the Act to recognize straight-line depreciation or normalization with respect to expansion property only does not mean they were denied authority to *permit* changes from flow-through to normalization with respect to property as to which an election was not available or was not exercised.

The election provision was written into the Act as a separate and distinct right conferred upon the utility to discontinue flow-through accounting on expansion property by "electing" to do so within the 180-day period prescribed. By refusing to consent to normalization, the agencies could force the use of straight-line depreciation. They could not, however, prevent the discontinuation of flow-through with respect to such property. The utility's right in this respect was separate, apart from and in addition to its right to request agency permission to discontinue flow-through and the agency's discretion to grant that request. Both the Act and its legislative history confirm this.

The Court is fundamentally wrong in its statement that "Congress has pondered the question [of permitting the discontinuation of flow-through when liberalized depreciation no longer results in a tax saving] and has exercised what was formerly the FPC's prerogative for it." 462 F.2d at 864.

Neither the election provision nor any other provision of the Act indicates any intention to limit agency discretion to permit changes from flow-through to normalization. No reason or purpose is suggested by the Act or its legislative history for Congress' undertaking to do so, and none exists.

THE FREEZE COMMENT

Unwarranted importance is placed by the lower Court on reference in the committee reports to a "'freeze' [of] the current situation regarding methods of depreciation." These statements are read by the Court below as indicating a congressional intent to prevent *any* changes in depreciation methods *or rate treatment* of such methods other than through the election provision. Specifically in this regard, the Court said:

> ". . . if we bear in mind the congressional intent generally "to freeze" the present depreciation situation, it appears logical that the permissible shift in accounting practices would be limited, . . .".[9] 462 F.2d at 870.

The reference in the House Report to a general "freeze" could not have been intended to preclude changes to normalization because the express language of the Act, as well as its stated purpose, was to the contrary. The lower Court recognized that under the House bill the taxpayer could discontinue flow-through with the consent of the regulatory

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[9] The lower court's interpretation is also contrary to the provisions of § 167 of the Internal Revenue Code which permits taxpayers, including regulated utilities, to shift from accelerated depreciation to straight-line depreciation at any time. Such changes are ordinarily made at the time when straight-line depreciation would exceed liberalized depreciation. The blanket prohibition against change which the lower Court reads into the Act would deny the utilities and their ate payers the benefits of this section.

agency. 462 F.2d at 862. Obviously the House contemplated no overall freeze and could not have intended the general "freeze" comment to have that effect. This language was simply carried forward with minor changes into subsequent Senate and Conference Committee Reports relating to their respective versions of the Act, both of which contained specific provisions for changes.

The "freeze" comment appears immediately following a reference to the suggestion of the Federal Power Commission that regulated utilities be required to use straight-line depreciation exclusively. The report explains that to do so would in many cases place the utilities at an unfair disadvantage, and then states that the committee had determined in general to freeze the current situation regarding methods of depreciation.

This, however, is not at all inconsistent with the continued discretion in the regulatory agency to permit a utility employing liberalized depreciation to base its rates on normalized taxes when the facts and circumstances justify such a change. Indeed, the term "current situation" may be interpreted as embracing not only the particular method of accounting used by the utility, but also the judicially recognized discretionary right in the regulatory agencies to permit a change to straight-line depreciation or normalization when current circumstances make it clear that liberalized depreciation would no longer result in a tax saving for the particular utility.

As Texas Gas notes, the "freeze" relates to changes from slower to faster methods of depreciation. As interpreted by the lower Court, however, it would prevent the Commission from ever giving effect to the *fact* that the 1964 conditions and circumstances of *Alabama-Tennessee* had changed to the extent that a different method was more appropriate.

Congress, having changed the tax laws so that liberalized depreciation would no longer result in a tax saving, it is anomolous to attribute to it the intention to deny the Federal Power Commission the discretionary authority to reflect the *effect* of such change by permitting the discontinuation of flow-through and thus protecting future customers against discriminatory rate treatment. Had Congress intended to limit agency discretion in this manner, it would surely have expressed itself more clearly than it did in the "freeze" comments on which the Court below placed such emphasis. Cf., *Alabama-Tennessee Natural Gas Co.* v. *F.P.C., supra,* 359 F.2d at p. 331.

THE ASSUMED DUTY

The lower Court further appeared to believe that the Commission was required to fix utility rates on the basis of "actual, present [tax] expenditures" alone. It stated that the Act did not purport to modify the Commission's "duty" to set rates on this basis. 462 F.2d at 863. The short answer to the lower court's comment is that the Commission has no such duty to be modified. It has been uniformly recognized that flow-through is inappropriate if, with respect to the particular utility, liberalized depreciation results in a tax deferral rather than a tax saving.[10] Addressing itself to this issue in *City of Chicago* v. *Federal Power Commission, supra,* the same court had stated:

> ". . . In some cases, normalization of tax deferrals is required lest future consumers be compelled to subsidize present consumers being served by the operations accruing tax liabilities." 385 F.2d at 633.

[10] See e.g., *City of Alton* v. *Commerce Commission,* 19 Ill. 2d 76, 165 N.E. 2d 513, cited and quoted from at length in both *Cities of Lexington, Kentucky et al* v. *FPC, supra* at p. 113 (which affirmed the Commission's approval of normalization) and *Alabama-Tennessee Natural Gas Co.* v. *FPC, supra* at p. 338 (which affirmed the Commission's requirement of flow-through).

Furthermore, the Court's assumption is contrary both to the Act itself which recognizes "normalization" as an appropriate method of fixing the rates of utilities which employ liberalized depreciation and to its affirmance of the Commission's Order No. 404, which permitted normalization for utilities which had made the election. This Court denied certiorari with respect to such holding in *Memphis Light, Gas & Water Division* v. *F.P.C.*, No. 72-96, October Term 1972.

CONCLUSION

For the reasons stated, the judgment of the lower Court should be reversed insofar as it vacated Commission's Opinions 578 and 578-A, and the action of the Commission in such Opinions should be affirmed.

Respectfully submitted,

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February 1, 1973

CERTIFICATE OF SERVICE

I certify that I have this day served the foregoing Motion for Leave to File Amicus Curiae Brief and Brief of The Independent Natural Gas Association of America, Amicus Curiae, in Support of Petitioners, on all parties to the proceedings in accordance with the requirements of this Court's Rule 33.

DATED at Washington, D. C. this first day of February, 1973.

/s/ JEROME J. McGRATH
JEROME J. McGRATH

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*,

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR PETITIONER, TEXAS GAS TRANSMISSION CORPORATION

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IN THE

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OCTOBER TERM, 1972

No. 72-488

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v.

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On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF FOR PETITIONER TEXAS GAS TRANSMISSION CORPORATION

OPINIONS BELOW

The initial opinion of the Court of Appeals (FPC Pet. 17-39) and its opinion on rehearing (FPC Pet. 41-53) are reported at 462 F.2d 853, 865. The initial opinion (Opinion No. 578) of the Federal Power Commission (R. 100-111), and its opinion on rehearing (Opinion No. 578-A, R. 145-149) are reported at 43 FPC 824 and 44 FPC 140, respectively.

JURISDICTION

The judgment of the Court of Appeals was entered on February 18, 1972 (FPC Pet. 55-56). Petitions for rehearing filed by the Commission and Texas Gas Transmission Corporation (Texas Gas) were denied on May 11, 1972. The petition for a writ of certiorari was filed in this case on September 23, 1972, within the time for filing such petitions as extended by order of the Chief Justice dated August 4, 1972. The petition for a writ of certiorari in this case was granted on December 4, 1972. The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 487, *et seq.*, 26 U.S.C. § 167(1) are set forth at FPC Pet. 73-78.

QUESTION PRESENTED

Whether Congress intended by Section 441 of the Tax Reform Act of 1969, to withdraw from the Federal Power Commission (and other agencies charged with similar regulatory responsibilities) the authority and discretion to permit a utility to change, for rate-making purposes, its method of tax depreciation for existing and new non-expansion properties from liberalized depreciation with flow-through (1) to liberalized depreciation with normalization or (2) to straight-line depreciation.[1]

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[1] As used in this brief, the term "existing property" means "pre-1970 property", "new property" means "post-1969 property" and "expansion property" means post-1969 property which "increases the productive or operational capacity of the taxpayer • • • and does not represent the replacement of existing capacity" as defined in Section 441(a) of the 1969 Tax Reform Act.

STATEMENT

Background

Prior to the enactment of Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, the utilities had generally used the straight-line depreciation method for determining federal income tax expense. Under this method, annual depreciation is uniform over the asset's life. Section 167 authorized taxpayers to compute tax depreciation, in addition to straight-line, by one of several accelerated or "liberalized" depreciation methods. Under any of these liberalized methods, annual depreciation is higher in the asset's early years and lower in its later years than under the straight-line method, and conversely, the federal income tax payment is lower in the early years and higher in the later years. Under all the depreciation methods here involved—straight-line and liberalized—the aggregate tax depreciation over the life of an asset never exceeds its total depreciable value.[3]

In enacting Section 167, the Congress intended to increase available working capital for all segments of the American economy to assist in the modernization and expansion of industrial capacity. H. Rep. 1337, 83d Cong.; S. Rep. 1662, 83d Cong., *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 316 F.2d 659, 662 (D.C. Cir. 1963).

In the early years following the enactment of Section 167, the Commission determined that the use of liberalized depreciation resulted in a tax deferral, and that the income tax expense allowed in the cost of service should be "normalized" for rate purposes,

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[3] There is no question here with regard to book depreciation which still is largely determined on the straight-line method.

i.e., the income tax allowed should be computed on the basis of straight-line depreciation and the difference between the taxes thus computed and the actual taxes payable under liberalized depreciation should be kept in a reserve account to be available, as needed, to pay the higher income taxes of later years. See, *e.g.*, *Amere Gas Utilities Co.*, 15 FPC 760, 781 (1956). In so doing the Commission reasoned that present rate payers would not benefit at the expense of future rate payers, and *vice versa*. This Commission position was affirmed by the Fourth Circuit as being a matter within the Commission's special expertise. See, *e.g.*, *City of Lexington* v. *F.P.C.*, 295 F.2d 109, 114 (4th Cir. 1961).

Several years later (1964), after its membership had changed substantially, the Commission (3-2) reversed this earlier decision by finding that the utilization of liberalized depreciation generally resulted in a permanent tax savings and directed that these "savings" should "flow-through" to the customers, in the form of reduced rates by computing income tax allowances on the basis of liberalized depreciation. *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 (1964) affirmed *sub nom.*, *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F.2d 318 (5th Cir., 1966) *cert. denied* 385 U.S. 847 (1966).

Two years later (1966), the Commission (3-2) decided that, for rate purposes, it would impute the use of liberalized tax depreciation to any company which shifted from liberalized depreciation to straight-line depreciation and would flow through the resulting imputed tax "savings" to the rate-payers. See *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), affirmed, 388 F.2d 444 (7th Cir., 1968), *cert. denied*, 392 U.S. 928 (1968).

The courts, in all three cases, recognized that the regulation of the tax depreciation policies followed by jurisdictional companies for rate purposes lay within the Commission's discretion.[3]

As we will show below, with the passage of the Tax Reform Act of 1969, a vital premise of the Commission's flow-through policy disappeared; the tax reduction ceased to be a "saving" and became a mere deferral.

Section 441(a) of the Tax Reform Act of 1969

As shown in detail, *infra*, pp. 42-51, the legislative history as well as the language of Section 441(a) establish the serious concern which the Congress had, over the loss of tax revenues as a result of the actions taken, or threatened, by regulatory agencies in the rate treatment of liberalized depreciation. (H. Rep. No. 91-413, Part I, 91st Cong., 1st Sess., p. 132; App. A, *infra*, p. 78).[4] In order to forestall this continuing loss of tax revenues, the House Ways and Means Committee proposed and the House adopted the following three general rules (*id.* at 133):

> "(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

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[3] The Commission has consistently regarded the treatment of liberalized depreciation in a regulatory context as a matter of administrative discretion. See, *e.g.*, *Alabama-Tennessee Natural Gas Co.*, 31 FPC at 216; *Natural Gas Pipeline Co.*, 33 FPC 574, 578 (1965), vacated on other grounds *sub nom. City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967), *cert. denied sub nom. P.S.C. of Wisconsin* v. *F.P.C.*, 390 U.S. 945 (1968).

[4] In view of their importance to the proper disposition of this proceeding, we have reproduced for the Court's convenience in Appendices A, B and C hereto, the entire discussion of tax depreciation for regulated utilities in the reports of House, Senate and Conference Committees, respectively.

"(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

"(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

As also shown in detail, *infra*, pp. 16-27, the Senate Committee adopted the same three general rules, and provided, in addition, a *supplemental*[5] privilege to regulated utilities by way of an election, with respect to *existing* as well as *new* property, which was not available under the House version (see S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 172-173; App. B, *infra*, pp. 82-83). As further shown, *infra*, pp. 28-32, the Conference Committee made no changes in the general rules. However, it did revise the election provided in the Senate bill to exclude existing properties entirely and new properties other than expansion property from its coverage. See H. Rep. No. 91-782, 91st Cong., 1st Sess., pp. 312-313, App. C., *infra*, pp. 90-91.

The Proceedings Before the Commission

Prior to the enactment of the Tax Reform Act of 1969, Texas Gas, like most of the utilities regulated by the Commission, and under compulsion of *Alabama-Tennessee* and *Midwestern, supra,* was utilizing liberalized depreciation with flow-through. Also prior to the passage of the Tax Reform Act, Texas Gas filed, pur-

[5] Emphasis supplied throughout unless otherwise indicated.

suant to Section 4(e) of the Natural Gas Act 15 U.S.C. § 717c(e), a proposal to increase its rates which *inter alia* would permit it to recover the increased taxes associated with its request to return to a straight-line method of tax depreciation with respect to *all* of its qualified property. (R. 1399).

After the passage of the Tax Reform Act and during the course of the above described rate proceeding, Texas Gas advised the Commission of its intent to exercise the election provided in Section 441 and to use, with Commission permission, liberalized income tax depreciation with normalization for its *expansion* properties. However, Texas Gas requested Commission assurance, before it made the election, that it would be permitted to change to straight-line, or alternatively and preferably, to normalization for its *existing and new non-expansion* properties. If it made the election without such assurance, the Company urged, it would be confronted with a continual loss of income tax depreciation deductions, necessitating further and repeated applications for rate increases (R. 2694-5).

In May, 1970, the Commission issued Order No. 404, 43 FPC 740, announcing its intention to permit companies subject to its regulation, which invoked the election, to use liberalized depreciation with normalization for the expansion properties.

In Opinion No. 578, issued on June 3, 1970, the Commission granted the Company permission to shift to normalization for the rest of its properties (R. 100-111).[6] The Commission pointed out that its premise in *Alabama-Tennessee, supra*, that the use of liberalized depreciation resulted in permanent tax savings for

[6] *I.e.*, existing properties and new non-expansion properties.

companies with growing or stable plant, was no longer valid for companies, such as Texas Gas, which had elected to abandon flow-through for their expansion properties (R. 108). As a result, the Commission found that requiring Texas Gas, nevertheless, to continue to use flow-through for its existing and new non-expansion properties would result in the Company's tax component increasing constantly with a resulting continual need for increased rates (R. 108, 110).

Accordingly, the Commission concluded that permitting Texas Gas, in such circumstances, to shift to normalization for its existing and new non-expansion properties offered "more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases" (R. 109). In addition, the Commission required Texas Gas to place the difference between the taxes due and the taxes allowed as a result of using normalization in a special reserve which would be excluded from the rate base on which the return allowed is computed with the result that the consumers would share in the benefits of normalization (R. 111).

Thereafter, on June 8, 1970, Texas Gas exercised its election not to have flow-through apply to its expansion property and commenced normalization of the tax expenses on all of its utility property as of January 1, 1970. The normalized taxes have been collected in Texas Gas' rates since January 12, 1970.

The Decision of the Court Below

The court below affirmed the Commission's action in Order No. 404 permitting companies on flow-through to use normalization for expansion properties (FPC

Pet. 20-29).[1] However, it set aside the Commission's action in Opinion No. 578 permitting Texas Gas to change to normalization for its existing and new non-expansion properties holding that Texas Gas ". . . is specifically prohibited, under the final version of the bill . . ." from abandoning flow-through (FPC Pet. 34). This is the keystone finding of the court's conclusion. It is based upon the premise that, by virtue of the revisions proposed by the Senate and Conference Committees, the final version of the Tax Reform Act of 1969 withdrew from the Federal Power Commission (and other regulatory agencies) once the 180-day period of the election had expired, the power and discretion to permit a regulated utility to switch from flow-through to either normalization or straight-line depreciation with respect to any of its properties for rate-making purposes.

SUMMARY OF ARGUMENT

I.

A. The Court below recognized that "the Commission and Texas Gas' position here [was] clearly justified" under the third general rule as recommended by the House Committee and adopted by the House. However, it held that the Senate Committee intended to replace that rule with a right of election. But, in so holding, the Court erred by ignoring the express adoption by the Senate as a "committee amendment", of a rule virtually identical in language to the House's third rule. The only significant difference between the two is the inclusion in the Senate version of the paren-

[1] This Court has denied certiorari on October 16, 1972, No. 72-96; 93 S. Ct. 234.

thetical phrase "except as provided under the Committee's amendment discussed below".

However, when read in light of the sentence structure and punctuation, this phrase plainly was intended to refer to an *additional* means (i.e., the right of election) by which a taxpayer could discontinue the use of flow-through. This reading is buttressed (1) by the Senate Committee's discussion of the application of a comparable rule to new properties and (2) by the identity in the Senate and House Committee's estimates as to the revenue increases expected to result from those amendments, exclusive of the right of election.

The Court compounded this error by focusing its consideration of the Senate version entirely upon that Committee's discussion of the proposed election. The Court was misled by the apparent overlap between the third rule and the right of election, since under both, a company on flow-through needs agency permission to change to normalization. However, the right of election has a different operational impact than the third rule, and of course, operates in a different time period, i.e., 180 days for the right of election as compared to an indefinite period with respect to the third rule. Thus, there is no overlap and there is no reason why the two cannot co-exist as intended by the Senate Committee.

B. Likewise misplaced is the Court's reliance upon the Conference Committee's report as support for its result. Not only was there no disagreement between the two Houses to be resolved by the Conference Committee, but the language of that Committee's report, relied on by the Court below, does not provide the sup-

port which the Court purported to see in it. In contrast, the Conference Report is completely silent on the matter, and since several members of the House Committee were very upset about the revenue losses resulting from the use of flow-through, it is difficult to believe that, as House conferees, they would have agreed to "freeze" companies on flow-through to that method, let alone that they would refrain from discussing such an agreement, if it existed, in the Conference report.

That the bill, as enacted, included the third general rule as well as the election as limited by the Conference Committee is also clear from the General Explanation of the 1969 Tax Reform Act subsequently prepared and issued by the Joint Committee Staff. The Court's various aspersions upon this document fall short of the mark; read with an acceptance of the coexistence of the third general rule and the right of election, the General Explanation is clear and wholly devoid of confusion and uncertainty.

II.

A. The Court of Appeals' holding derives no support from the Congressional purposes in enacting Section 441. Contrary to the Court's ruling, the fact that Congress intended a "freeze" generally with respect to methods of tax depreciation does not mean that Congress intended thereby to bar regulatory agencies from permitting companies on flow-through to change to other methods of tax depreciation. The Court's heavy reliance in this regard upon the House Report is misplaced since that report also admittedly contains the third general rule. Moreover, it misreads the nature of the "freeze" itself, which is built into the

three general rules and constitutes the Congressional resolution of a dilemma.

On the one hand, the revenue losses resulting from the trend among regulatory agencies to require companies to change to depreciation with flow-through was a matter of grave concern to the Committee. As far as the Committee was concerned, the rate reductions resulting from these trends constituted an anticipated and unwarranted "subsidy" for the rate payers at the expense of the taxpayers. On the other hand, they recognized the unsoundness of adopting the recommendation of the Federal Power Commission that all regulated companies be required to revert to straight-line depreciation since it would place many of these companies at a disadvantage competitively with other, particularly unregulated, companies.

To resolve the dilemma, Congress adopted the three general rules. On the one hand, they imposed a freeze by prohibiting a company from changing to *faster* methods of tax depreciation, thereby forestalling any increase in the tax revenue losses. On the other hand, the three rules do not impose any statutory barrier to changing to *slower* methods of tax depreciation, thereby providing the leeway needed to protect the competitive position of regulated companies while, at the same time, keeping the way open for reduction in revenue losses through changes to slower methods of tax depreciation.

In contrast, the Court's version of the Congressional resolution of this dilemma would destroy flexibility and ability to accommodate to changing conditions. It would prevent the reduction in tax revenue losses which would come about when a company on flow-

through changes to a slower method of tax depreciation. And it would perpetuate the very type of tax revenue loss which the Act's legislative history plainly discloses was obnoxious to many of the responsible members of Congress.

B. Contrary to the implication of the Court below and the explicit contention of respondent Memphis, Congress fully recognized that rate increases would be necessary to reflect changes to slower methods of tax depreciation. The Summary prepared by the Joint Committee Staff cited by the Court below and Memphis is entirely irrelevant, since it relates solely to the bill as it passed the House of Representatives. The House bill is different from the bill as passed by the Senate and from the bill as finally enacted in the critical respect that the latter bills contained an added right of election to change from flow-through to other methods of tax depreciation, a right, limited in the final bill, to new expansion properties.

The exercise of this election, as added by these later bills, as the Commission found, did away with the tax savings needed to avoid the future repayment of taxes avoided earlier by utilizing liberalized depreciation. The legislative history shows that Congress was fully aware that the wiping out of the benefits of such "tax reductions, tax savings," (House Hearings, p. 3569) would create a need for rate increases to offset the loss of these benefits.

III.

The Commission's action in permitting Texas Gas to change from flow-through to normalization for its existing and new non-expansion properties is well

within the Commission discretion, which under established precedents, is extremely broad, particularly with regard to such technical matters involving Commission expertise.[8]

Since the Commission decision in *Alabama-Tennessee, supra*, holding that the use of liberalized depreciation results in a tax savings, there have been at least two dramatic changes in circumstances. First, a critical shortage of natural gas has developed, which undercuts the *Alabama-Tennessee* finding that the natural gas industry will be growing, or at least a stable industry, for the indefinite future. Second, Texas Gas' exercise of the right of election has the effect of rendering the tax depreciation in the new expansion facilities no longer available to offset the declining tax depreciation on the older facilities, as contemplated in *Alabama-Tennessee.*

In addition, the Commission found and the evidence shows, that normalization would help stabilize Texas Gas' rates and would enhance the quality of its securities. Accordingly, it is apparent that the Commission decision is amply supported.

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[8] We read the decision of the court below as holding that, if the Federal Power Commission retained discretion under the Tax Reform Act of 1969 to permit a utility to change its method of computing tax depreciation from liberalized depreciation with flow-through to a slower method for rate purposes, then the proposal of Texas Gas was clearly justified. Our discussion of the Commission's exercise of its discretion in this brief is presented in order to avoid a remand to the court below should this Court disagree with that reading of the decision below.

ARGUMENT

I.

SECTION 441 OF THE 1969 TAX REFORM ACT DOES NOT BAR THE COMMISSION FROM PERMITTING COMPANIES ON FLOW-THROUGH TO CHANGE TO OTHER METHODS OF TAX DEPRECIATION FOR THEIR EXISTING AND NEW NON-EXPANSION PROPERTIES

In holding that Congress intended Section 441 of the 1969 Tax Reform Act to preclude regulatory agencies from permitting regulated utilities such as Texas Gas to change from flow-through to other methods of tax depreciation for their existing and new non-expansion properties, the Court of Appeals expressly recognized that "The Commission's and Texas Gas' positions here [was] clearly justified" under the third general rule as provided in the House bill (FPC Pet. 32),[9] and based its contrary holding primarily on its reading of the Senate and Conference Committee versions of that section.[10] We show below that the Court's

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[9] As recognized by the Court below (FPC Pet. 31-32), the third general rule provided in the House Bill would have been applicable to utilities such as Texas Gas which had been taking liberalized depreciation and flowing the benefits thus deferred through to its customers. By providing in the third general rule that companies on flow-through must continue to use flow-through "unless the appropriate regulatory agency permits a change as to that property" (See *supra*, p. 6), the House Committee makes clear its intent that changes by a company on flow-through to other methods of tax depreciation may be made but are subject to the approval of the regulatory agency involved.

[10] The Court explained its total reliance upon legislative history with the comment that "the intent of Congress is not readily apparent on the plain face of this statute" FPC Pet. 51 fn. 8. However, as summarized in the Court's main opinion (FPC Pet. 30-31):

> "• • • Under Section 441(a), a 'reasonable allowance' may be computed in either of two ways: one, a 'subsection (1) method,' refers to the straight-line method of depreciation,

reading of those Committee versions is grossly in error and that, in fact, they did not change or modify the third general rule as provided by the House Committee and adopted by the House.

A. The Senate Committee Did Not Intend To Replace the House's Third Rule with a Limited Election

Rejecting the contention that the Senate had intended the right of election as an addition to, not a replacement for, the third general rule provided by the House, the Court below in its original opinion, held that the bill recommended by the Senate Finance Committee and passed by the Senate struck out the House's third general rule and substituted in its stead with respect to existing and new properties (FPC Pet. 32-33):

> "* * * an election to be made within 180 days after the date of enactment of the bill for a utility * * * to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method * * *."

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while the other is 'the applicable 1968 method for such property' but 'only if the taxpayer uses a normalization method of accounting.' (fn. omitted.) Section 441(a), however, provides an exception to the normalization requirement for using the second method by allowing a utility using the flow-through method to continue doing so."

While the *full* impact of these provisions may not be crystal clear upon a first reading, it is readily apparent upon careful consideration that the three rules are included within the above description, particularly in light of the "may" language used in the statute in referring to companies on flow-through (See FPC Pet 73) and the past recognition that the question of the appropriate method of tax depreciation is a matter of Commission discretion. See *supra*, pp. 4-5. In addition, of course, these provisions are separate and distinct from the right of election which is set out in Section 441(a)(4)(A). In any case, as we show in detail in the text, the Court's reading of the legislative history, on which it places primary reliance, likewise does not support its result.

Continuing, the Court below reasoned that since the Conference Committee limited the 180-day election to expansion properties, the result was entirely to bar the Commission (and other regulatory agencies) from permitting companies subject to its jurisdiction from thereafter changing from flow-through to other methods of tax depreciation for their other properties (FPC Pet. 34).

Seeking further to buttress this conclusion, the Court of Appeals, in its opinion on rehearing, undertook to chart its view of the revisions in the legislation as it made its way through Congress (FPC Pet. 44), and insisted that there was "no language to the contrary" to refute its result that "the Senate limited * * * *all* changes re both expansion and non-expansion property to a 180-day election period." (Emphasis in original.) (FPC Pet. 43-45).

It is our position not only that there was "language to the contrary," in the report of the Senate Committee but that that language, properly read and construed, discloses, beyond any possible doubt, that the Senate Committee intended the 180-day election to be an *addition* to—not a *replacement* for—the House's third general rule.

1. The Court Below Ignored the Language in the Senate Committee Report Clearly Including an Acceptance of the House's Third General Rule

To begin with, the Senate Committee Report explicitly states (S. Rep. No. 91-552, *supra*, at pp. 172-173, App. B, *infra*, pp. 82-83):

> "*Both* the House bill *and* the committee amendments provide that in the case of existing property,[11] the following rules are to apply:
>
> * * * *

[11] While our argument is formulated in terms of "existing property", it applies equally to the new non-expansion properties.

> "(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the Committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property."

The use of the conjunctions "both * * * and" in the above excerpt plainly evidences the intent of the Senate Committee to prescribe the same third general rule as provided in the House bill.[12]

In addition, the formulation of that rule as set out in the Senate Committee Report is itself virtually identical to the third rule contained in the House Committee report (H. Rep. No. 413, *supra*, at 133, App. A, *infra*, p. 79):

> "(3) If the taxpayer is taking accelerated deprecation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

The only significant difference between the two formulations is the inclusion of the parenthetical phrase "except as provided under the Committee amendments which are discussed below" in the Senate Committee's version. However, this parenthetical reference to the right of election added by the Senate Committee obviously does not manifest an intent to eliminate the applicability of the remainder of the entire text em-

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[12] There is no question but that the first two rules set out in the Senate Report track those proposed by the House Committee and adopted by the House.

bodying the third general rule proposed by the House and not included within the parenthesis.

To support such a result, it would be necessary for the parenthetical phrase to be read as being intended somehow to wipe out the clause "unless the appropriate regulatory agency permits a change as to that property" following after the parenthesis. But the position of the parenthetical phrase in the sentence (i.e., immediately before the "unless" clause), together with the comma separating the parenthetical phrase from the following "unless" clause, plainly belies the validity of any such construction.

Rather, read as indicated by (1) the sentence structure, (2) the presence of the limiting "except" in the parenthetical phrase, and (3) the comma separating the parenthetical phrase from the following clause, it is clear that the parenthetical phrase is intended to modify the clause "then the taxpayer would continue to do so" immediately preceding the parenthesis. So read, the parenthetical phrase serves to refer to a method being added by the Senate Committee under which the taxpayer would not have to "continue to do so", i.e., would not have to continue on flow-through. In other words, the parenthetical phrase is intended to indicate a method, *in addition to* that provided by the "unless" clause, by which a taxpayer on flow-through could change to other methods of tax depreciation.

That such reading of the parenthetical phrase conforms to the intent of the Senate Committee is reinforced by that Committee's proposed tax depreciation treatment for *new* properties of companies on flow-through. Thus, immediately following the language

just discussed relating to existing properties, the Senate Committee Report states (S. Rep. No. 91-552, *supra*, at p. 173; App. B, *infra*, p. 83):

> "Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies) * * *."

The reference to "both versions" and the use again of the limiting "exception" language in the parenthetical clause serve to emphasize the primary intent of the Senate Committee to track the general rule for such new property as adopted by the House. In addition, it should be noted that while the parenthetical "unless" clause in the above excerpt comes after the non-parenthetical "unless" clause, any problem whether the parenthetical clause was in substitution for or in addition to the other clause is entirely eliminated by the use of the parallel "unless" structure in both clauses and the coupling of the two clauses by the disjunctive "or".

Thus, the discussion relating to new property makes it plain that the Senate Committee intended the right of election as an additional, not a substitute, method by which companies on flow through and not exercising the 180-day election could shift to other methods of tax depreciation for such properties. And since the Senate Committee proposed that companies on flow-through should have the same right of election for their existing properties as well as for their new prop-

erties, the fact that the election for new properties was clearly in addition to, not a replacement for, the general rule, strongly supports the same result with respect to existing properties.

Finally, it should be noted that the revenue increases resulting under the Senate version of Section 441, apart from those brought about by the exercise of the right of election, are exactly the same as those estimated by the House Committee. Thus, the House Committee report states (at p. 134, App. A, *infra*, p. 80):

> "The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974 and $310 million in 1979,"

and, in like manner the Senate Committee report states (at p. 176, App. B, *infra*, p. 89):

> "The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election."

Certainly, if the Senate Committee had intended for the right of election to replace the third general rule, it would have reduced its estimate of revenue increases to reflect the effect of the reduction in shifts to slower methods of tax depreciation. The facts (1) that the Senate Committee used the same estimate of revenue increases as the House and (2) that it treated the revenue increases expected under the right of election

separately, operate further to demonstrate that the Senate Committee intended the same three substantive rules to be applicable, with the right of election being an addition to, and not a replacement of, the third rule.

2. The Court Below Improperly Focused Upon the Language in the Senate Report Dealing With the Proposed Election

In reaching its conclusion that the Senate Bill replaced the third general rule with the right of election, the Court below completely ignored the clear statements in the Senate Committee Report. Instead, it focused its entire attention upon the language in that report dealing with the proposed election. This is apparent from the following excerpt from the Court of Appeals' main opinion, which consists of its entire discussion of the Senate Committee Report on this aspect of the case (FPC Pet. 32):

> "The bill as reported by the Senate Finance Committee gave regulated utilities using liberalized depreciation with flow-through an election to abandon that method of depreciation both for 'pre-1970' property (a change from 'existing' property in the House version) and 'post-1969' property ('other' property in the House bill). The Senate Report states in regard to the altered right of election:
>
> 'The [Senate] committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the regulatory agency, or permit it with the permission of the regulatory

agency to shift to the normalization method (that is, to come under general rules of the bill). This election applies both as to new and *existing* property.' (footnote omitted).

"Under the Senate version of the bill, therefore, Texas Gas would have been permitted to shift from liberalized depreciation with flow-through either to straight-line depreciation, or, with the FPC's approval, to liberalized depreciation with normalization." (Emphasis in original).[18]

The Court's opinion does not disclose its reasoning or justification for thus focusing upon the Senate Committee's discussion of the right of election to the exclusion of that Committee's discussion of the third general rule. Consequently, one can only speculate as to its rationale for concluding that the Senate Committee intended the election to be a substitute for, rather than an addition to, the third general rule. However, it would appear that the Court was misled by an apparent overlap between the third general rule, on the one hand, and the proposed election, on the other.

This apparent overlap stems from the fact that under both the third general rule and the right of election, a company on flow-through needs agency permission to change to normalization; the only difference between the two appears to be one of duration—the election has a 180-day life, whereas the third general rule continues indefinitely. No such apparent overlap exists, however, with respect to changes to straight line de-

[18] The Court's opinion on rehearing casts no additional light. Its sole discussion of this problem is a reference to the "analysis" in its main opinion. See FPC Pet. p. 43.

preciation; under the election, a company on flow-through can change to straight line depreciation with or without agency permission whereas, under the third general rule, such a company needs agency permission to make such a change.[14]

But, contrary to the assumption of the Court below, the two parts of the proposed election were not intended as separate and distinct from each other with each having a counterpart, either the same or different, in the third general rule. Thus, the right to change to straight line depreciation in the election, with or without agency permission, was not intended as a revision of the provision in the third general rule permitting such a change to straight line depreciation only with agency permission. Likewise, the provision in the election permitting changes to normalization with agency permission only for a 180-day period was not intended as a revision of the provision in the third general rule permitting such change to normalization without time limit. Rather, the two parts of the election were collectively intended as mutually interdependent aspects of a single package. The two parts of the election, taken together, have an operational impact different from the two parts of the third rule. Hence, they were

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[14] That this apparent overlap between the third general rule and the proposed election in fact underlies the Court's approach is indicated by the observation in the Court's opinion on rehearing that FPC Pet. 43-45):

> "Thus, between the initial House and Senate versions of Section 441(a), two differences emerge with respect to Situation III [flow-through] and to shifting from flow-through: First, under the Senate version, in contrast to the House, FPC approval is *not* required to shift from the flow-through to the straight-line method; and second, the Senate limited • • • *all* changes re both expansion and non-expansion property to a 180-day election period." (Emphasis in original).

designed to confront the regulatory agency involved with different situations in the different time periods in which they were operative.

Thus, the provision in the election that a company on flow-through could change to straight line depreciation without agency permission during the 180-day life of the election (1) assured a company on flow-through that it could change to another method of tax depreciation during the 180-day life of the election and (2) was designed to put pressure upon the regulatory agencies when confronted with the problem during that period more freely to grant to such a company permission to change to normalization. As occurred in the related Texas Gas proceeding, Texas Gas elected to change to straight-line depreciation during the 180-day life of the election without Commission permission with respect to its new expansion properties; however, since it preferred changing to normalization, it left it up to the Commission whether to permit it to change to normalization as an alternative to changing to straight-line depreciation. Since the Commission also regarded the change to normalization as preferable to straight-line depreciation, it gave Texas Gas permission to change to normalization with respect to those properties. See FPC Order No. 404, 43 FPC 740 (1970), *supra*, p. 7.

The third general rule requiring agency permission before a company on flow-through could change either to straight-line or normalization has no such operational effects. Under this rule, which is to remain in effect without time limit, companies on flow-through had no assurance that they would be permitted to change to another method of tax depreciation. Nor were the regulatory agencies subject to any legislative pressure

to permit any such change to another method of tax depreciation. Whether a company on flow-through could change to another method of tax depreciation and whether such change, if permitted, was to straight-line depreciation or normalization, were matters left for determination by the regulatory agency as an exercise of its discretion in the particular circumstances involved.

In view of these differences in operational effects and the election's 180-day *limited* life as compared to the *indefinite* life of the third general rule,[15] there is in fact no overlap between the election and the third general rule, and, contrary to the Court below, the Senate Committee did not intend the election to be treated as a substitute for, rather than as an addition to, the third general rule.

B. The Conference Committee Did Not Modify the Third General Rule

1. There Was No Disagreement with Regard to the Third General Rule Between the House and Senate Bills to be Resolved by the Conference Committee

The Court's further assumption that its conclusion was supported by the report of the Conference Committee is based primarily on its earlier conclusion that there was a disagreement between the House and Senate versions of the proposed legislation. According to the Court, since the Senate had replaced the House's third general rule with a 180-day election applicable to new and existing properties, the Conference Committee

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[15] Under the regulations issued by the Internal Revenue Service, the election, once exercised, is irrevocable. (See IRS Regs. Sec. 1.167(1)-4(i)). In contrast, of course, under the third rule, changes can be made as found to be appropriate by the regulatory agency as to property not covered by the election or as to which the election was not exercised.

properly undertook to resolve that disagreement, and that its resolution, limiting the election to new expansion properties, in turn operated entirely to bar the regulatory agencies from permitting companies on flow-through to change to any other method of tax depreciation. See FPC Pet. 43-45.

However, once it is recognized that the Senate accepted the third general rule and intended the election to be an addition to, not a substitute for, the third rule, then it becomes clear that there was no disagreement between the Senate and House versions on this score within the authority of the Conference Committee to resolve. (See Section 136 of the Legislative Reorganization Act of 1946, 2 U.S.C. 190(c)).[16] In addition, since the third general rule, as proposed by the House and accepted by the Senate, is separate and distinct from the Senate's proposed election, the action of the Conference Committee in limiting the election to new expansion properties did not operate to impose any limitation upon the operation of that rule.

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[16] Section 136 provides in pertinent part:

"(a) In any case in which a disagreement to an amendment in the nature of a substitute has been referred to conferees, it shall be in order for the conferees to report a substitute on the same subject matter; but they may not include in the report matter not committed to them by either House. They may, however, include in their report in any such case matter which is a germane modification of subjects in disagreement.

"(b) In any case in which the conferees violate subsection (a), the conference report shall be subject to a point of order."

See also: Constitution, Jefferson's Manual and Rules and Practice of the United States, 92nd Congress, Lewis Deschler, Parliamentarian, U. S. Govt. Pr., 1971, p. 270.

2. The Conference Committee Report Does Not in Fact Support the Court of Appeals' Conclusion

Contrary to the Court below, the Conference Committee did not, in fact, undertake to eliminate or modify, in any way, the third general rule as proposed by the House and accepted by the Senate. The Court purports to have found evidence of such an undertaking in the following statement in that Committee's Report (See FPC Pet. 33-34):

> "1. *Depreciation allowed regulated industries (sec. 167 of the code)*
>
> "The House bill provides that in the case of certain regulated industries (the furnishing or sale of . . . gas through a local distribution system, . . . and transportation of gas by pipeline) a taxpayer is *not permitted* to use accelerated depreciation *unless it normalizes* the current income tax reduction resulting from the use of such accelerated depreciation. . . .
>
> "*This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account.* Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.
>
> "The Senate amendments make the following changes in the House bill: . . . (d) *an election is permitted to be made within 180 days after the date of enactment by a company at present on flow-through to come under the rules of the bill;* . . .
>
> "*The conference substitute (sec. 441 of the substitute and sec. 167(1) of the code) follows the Senate amendment except that the special provision referred to in (e) above is stricken and the 180-day election (item (d), above) is modified to*

apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flow through method is to be available only to the extent the new property increases the productive or operational capacity of the company." (Emphasis by Court below).

According to the Court below, the effect of the italicized language in the second paragraph of the above quotation is, to quote that court (FPC Pet. 34), that "since Texas Gas has been employing liberalized depreciation with flow-through, it is specifically prohibited, under the final version of the bill, from abandoning such depreciation* * *".

But a careful reading of this excerpt belies the imposition of any such prohibition. The first two paragraphs plainly are intended only to summarize the three general rules provided in the House bill, with the first paragraph summarizing the House's proposed second rule, i.e., that a company on liberalized depreciation with normalization was not to continue liberalized depreciation unless it also continued to normalize. Accordingly, the reference implicit in "This rule", which constitutes the first two words of the second paragraph clearly is to the second rule and is intended to indicate that that rule did not apply to companies on flow-through. That is so, because, the text of the first sentence of the second paragraph is a clear reference to the third general rule, i.e., companies on flow-through are to remain on flow-through unless permitted by the regulatory agency to change to normalization or straight-line. In other words, the first sentence of the second paragraph is intended, *albeit* somewhat inartistically, as a statement of the third

general rule with the second sentence in that paragraph completing the summary of the three general rules, i.e., that companies on straight-line may not shift at all to any form of liberalized depreciation.

That the italicized language in the second paragraph does not contain the prohibition purportedly found therein by the Court below is further indicated by the facts (1) that only with the third paragraph of the excerpt did the Conference Committee reach the changes in the bill proposed by the Senate; and (2) that only in the fourth paragraph of the excerpt did the Conference Committee deal with its proposed resolution of the differences between the two bills. Significantly, while the third paragraph refers to the election added by the Senate bill and the fourth paragraph explains the limitation upon that election added by the Conference Committee, there is nothing in either of those paragraphs indicating that the election as proposed by the Senate, or as revised by the Conference Committee, was intended as a limitation upon, or a replacement of, the three general rules as proposed by the House.

Indeed, the absence of any such discussion is perhaps the strongest evidence possible—shy of an explicit affirmative statement—that there was no intention to limit or eliminate the third general rule. We show in greater detail, *infra*, pp. 42-48, that one of the principal areas, if not *the* principal area, of concern to the members of the House Committee in considering this problem was the increasing trend among regulatory agencies to require the utilities subject to their jurisdiction to use liberalized depreciation and to flow-through the benefits of that method of tax depreciation. The latter aspect of this trend caused particular concern since it was resulting in substantial tax revenue

losses which had not been anticipated originally. Consequently, in proposing the three general rules, the House Committee was seeking both to forestall an increase in the tax revenue losses which would result from a continuation of these trends and to reverse that trend by leaving the way open for changes to slower methods of tax depreciation.

In these circumstances, it is difficult to believe that the House conferees would have agreed to legislation under which, except for an election relating only to limited properties and available for only a limited time, companies on flow-through would remain on flow-through indefinitely, so that there would be an indefinite perpetuation of the related revenue losses. It is even more difficult to believe that assuming that the House conferees had, in fact, agreed to such a result, they had nevertheless failed to point out this departure from their previous position either in the text of the Conference Committee report itself or during the House debates on that report. Yet, the fact is that there is nothing either in that Committee report or the subsequent debates which, in any way, even intimates the existence of any such change in attitude or approach by the House conferees.

The absence of any indication of any such change is strong evidence that no such change was intended and that, to the contrary, the House Committee's aversion to flow-through continued to pervade the proposed legislation. Indeed, in line therewith, it is noteworthy that the Conference Committee report stated that the Committee had struck a special provision added by the Senate permitting "a company under specified circumstances to avoid the rules of the bill by changing from normalization to flow-through" (H. Rep. No. 91-782, *supra*, at p. 313, App. C, *infra*, p. 91).

3. The General Explanation of the Tax Reform Act Prepared by the Staff of the Joint Committee Further Indicates that the Bill as Agreed to in Conference Did Not Revise or Eliminate the Third General Rule

Subsequent to the enactment of the 1969 Tax Reform Act, the Staff of the Joint Committee on Internal Revenue Taxation issued a document dated December 3, 1970 entitled "General Explanation of the Tax Reform Act of 1969, H. R. 13270, 91st Congress, Public Law 91-172."[17] Examination of the General Explanation makes clear the Joint Staff's understanding that Section 441 as finally enacted included the third general rule and that it was separate and apart from the right of election as limited by the Conference Committee. The Joint Staff states, with respect to existing property, (General Explanation, p. 151):

* * * *

"(3) If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so (except for a special election procedure discussed below), unless the appropriate regulatory agency permits a change as to that property.* * *

"In the case of new property, the Act provides that if the taxpayer as of August 1, 1969, flowed through to its customers the benefits of accelerated depreciation then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change (or unless the election below applies)."

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[17] In its letter of transmittal accompanying this General Explanation, the Joint Staff notes that, unlike reports of the respective committees which explain the legislation as proposed by the Committees, there usually had not been any report to explain the final legislation as passed by the Congress and that, since there have been many changes between the Tax Reform Act as passed by the House or Senate and as finally enacted, it had prepared the Explanation to fill the gap and thereby to provide explanations of the Act as finally enacted (Joint Explanation, p. iii.)

and then on the following page 152, the General Explanation goes on:

> "As indicated above, for a limited period of time and to a limited extent utilities on flow-through could elect straight line depreciation or accelerated depreciation with flow-through.* * *"

By thus setting forth the third general rule separately from the right of election as well as separately for existing and for new properties (remember: the election as finally enacted extended only to new expansion properties), the Joint Staff plainly manifests its understanding that that third rule was intended as part of the final bill, separate and apart from the election.

In its opinion on rehearing, the Court below goes to great lengths in an effort to disparage the first of the above statements in the Joint Staff's General Explanation (See FPC Pet. 47-52). In this regard, the Court urges that the language used in that statement "was lifted, with only minor modifications, from the House and Senate reports, both of which were commenting on the instant House version of Section 441 (a)." (FPC Pet. 48-49). But, as shown, *supra*, at pp. 17-22, the language as lifted from both the House and Senate version, was addressed, as far as the Senate version was concerned, to *both* "the House bill *and* to the [Senate Committee] amendment." In short, the Senate version provided for the same third general rule as provided in "the House bill". Consequently, the fact that the General Explanation lifted its language in this regard from the House and Senate versions serves to emphasize the identity of the provisions of both versions with regard to the third general rule.

Further, the Court below claims (FPC Pet. 49) that "At best this language is confusing and uncertain; it

cannot carry the meaning ascribed to it by the Commission and Texas Gas, particularly in view of the following page 152, discussed *infra*." But again, the Court is in error—the language is confusing and uncertain only when read, as done by the Court below, to indicate that the election proposed by the Senate was intended to replace the third general rule. As explained earlier, the language is clear and there is no confusion or uncertainty when it is recognized that the Senate Committee intended the election as an addition to, not a replacement for, the third general rule. So read, there is no confusion that the right of election, described at p. 152 of the General Explanation, to which the Court below later referred (FPC Pet. 49-50), is separate and apart from the third general rule.

Again, the Court below asserts (FPC Pet. 49) that:

> "* * * [T]here never was at any time in any version of the House, Senate, or conferees, a power in the agency to compel or permit a company to change from any method of depreciation accounting to flow-through. To have included such a provision would have been directly contrary to the overall objective of this portion of the Act—'in general to "freeze" the current situation regarding methods of depreciation.'"

In so urging, the court below apparently had in mind the sentence in the excerpt on page 151 of the General Explanation (omitted from the quotation set out, *supra*, above) to the effect:

> "That is, the Act does not require the taxpayer to flow through, but it also does not affect any power the regulatory agency might have to require the taxpayer to flow through."

We agree that the sentence appears to be garbled and, as urged by the Court below, it would be inconsistent with the Act's purposes thereafter to permit companies to change *to* flow-through either *sua sponte* or pursuant to an order of its regulatory agency. See, *infra*, pp. 39-41. Indeed, as shown, *supra*, p. 31, the Conference Committee eliminated from the Senate version a proposal to permit changes to flow-through in certain limited instances.

However, the fact that Congress was opposed to changes *to* flow through does not help the construction of the Court below that, under Section 441, companies on flow-through were prohibited entirely from changing *from* flow-through with respect to existing properties and permitted to change *from* flow-through for new properties only for a limited period of time and with respect only to limited types of property. Likewise, that fact does not detract from our reading that Congress intended to include the House's third general rule in the bill as finally enacted so that companies on flow-through could change *from* flow-through to other methods of tax depreciation if permitted by the regulatory agency.

Finally, the Court below contends (FPC Pet. 51) that to:

> "take Texas Gas' and the Commission's evaluation of the words on page 151—and ignore page 152 completely—then the exception is for all property and swallows up the whole, thus vitiating any congressional intent 'to freeze' generally depreciation accounting practices for utilities."

But our reading of page 151 does not require an ignoring of page 152; it just involves a recognition that the third general rule, described on page 151, is separate and distinct from the right of election described on

page 152. For this reason, also, such recognition does not involve the exception swallowing up the whole or vice versa, for, as shown *supra*, pp. 24-25, the general rule and the election have different operational effects, and hence, there is no conceptual or factual obstacle to two existing side by side independently of the other. Nor does our reading vitiate the "freeze" intended by Congress; to the contrary, as shown, *infra*, pp. 37-53, our reading is entirely consistent with that "freeze."

II.

THE COURT'S CONCLUSION THAT SECTION 441 WITHDREW AGENCY AUTHORITY TO PERMIT COMPANIES ON FLOW-THROUGH TO CHANGE TO OTHER METHODS OF TAX DEPRECIATION IS INCONSISTENT WITH THE CONGRESSIONAL PURPOSES IN ENACTING THAT SECTION

The Court below sought further to buttress its conclusion that Section 441, as finally enacted, operated to withdraw agency authority to permit companies on flow-through to change to other methods of tax depreciation by referring to the Congressional purposes in enacting that provision. Thus, in its main opinion, the Court claimed that the Commission's holding permitting Texas Gas to change from flow-through to normalization with respect to its existing properties "produce[s] an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969" (FPC Pet. 34).

We will show that it is the conclusion of the Court below which is at odds with the Congressional purposes. Properly understood and evaluated, these Congressional purposes require the continued survival of authority in the regulatory agencies to determine whether, in the circumstances presented, it is appropriate to permit the company involved to change from flow-through to another method of tax depreciation.

A. The "Freeze" Was Intended Only To Bar Changes To Faster Methods of Tax Depreciation

In support of its result, the Court below claimed that its holding was in accord with the Congressional purpose to "freeze" the current situation regarding the methods of depreciation. Thus, in its main opinion, the Court asserted (FPC Pet. 34-35):

> "* * * The Report of the House Committee on Ways and Means states:
>
> 'Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.
>
> *'Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries.* (footnote omitted).
>
> "The Senate Report agreed with this perspective, stating in relevant part:
>
> 'Accordingly, the committee agrees with the House that is *appropriate to in general* [*sic*] *"freeze" the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more flourishing utility industries.'" (emphasis in original).

And in its opinion on rehearing, the Court further elaborated (FPC Pet. 46):

> "In permitting a taxpayer such as Texas Gas to shift from accelerated depreciation with flow-

through to straight-line depreciation with or without the appropriate agency's approval, the Senate was no doubt interested in increasing governmental revenues (since under flow-through the tax reduction is passed on to the utility's customers). The House, however, by limiting changes from flow-through either to straight-line or normalization *only with* agency approval, was reflecting the concern that emphasis on a shift to straight-line depreciation, as expressed by the Senate version, would place taxpayers such as Texas Gas at a competitive disavantage, both as to the sale of their products or services and as to their attractiveness to equity investors. (footnote omitted).

"Thus, the conferees' resolution of this disagreement in favor of the latter concern by limiting the extent to which regulated utilities may abandon flow-through reflects Congress' overall intent in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries."

But in concluding that the "freeze" thus intended by Congress supports its holding that Section 441 barred regulatory agencies from permitting companies on flow-through to change to other methods of tax depreciation, the Court below overlooked a number of significant factors and considerations. As a result, it is the Court's position—not that of Texas Gas and the Commission—which fails to give appropriate consideration to the overall Congressional objective to forestall prospective revenue losses, without handicapping the utility industry.[18]

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[18] As noted, *infra*, p. 49, the FPC recommended the elimination entirely of liberalized depreciation for the natural gas pipeline industry on the ground that that industry did not need the incentives thereby intended to be provided, and hence that the elimination thereof would not handicap it.

1. The House Report Provided Simultaneously for the Three General Rules and the "Freeze"

At the outset, it should be noted (1) that the House Committee report, on which the Court below places such heavy emphasis in support of its result, includes the three general rules dealing with the methods of tax depreciation to be available to regulated companies, and (2) that the third general rule thus included expressly provided that companies on flow-through could change to other methods of tax depreciation if permitted by their regulatory agency.

Indeed, as pointed out *supra* at p. 15, the Court itself expressly recognized that the Commission action herein would have been *fully justified* under the bill as recommended by the House Committee and adopted by the House. In other words, as far as the House bill was concerned, the existence of authority in the regulatory agencies to permit companies on flow-through to change to other methods of tax depreciation is wholly consistent with the "freeze" as envisioned under that bill.[18a]

2. The "Freeze" Is Built Into the Three General Rules

This brings us to the nature of the "freeze" itself and in this respect, the Court's view as to the freeze again does not accord with the Congressional intent. To be sure, as stated by the Court (FPC Pet. 46), "Congress intended to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy industries". But the "freeze" was not absolute; both

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[18a] Similarly, the Senate Committee provided for a freeze "in general" in substantially the same language as the House. However, as the Court below agrees, utilities could, under the 180-day election, shift from flow-through with respect to all their property, old as well as new. Therefore, it is perfectly apparent that the freeze language could not be interpreted as an absolute bar to shifts from flow-through.

the House Report (at p. 133, App. A, p. 79) and the Senate Report (at p. 172, App. B, p. 82) provide only for a freeze "in general". Moreover, Congress did not intend the freeze to be tied directly into the competitive status of particular utilities or industries. Rather the "freeze" is designed to be tied into the method of tax depreciation being used by the affected companies on the critical date and is built into the three general rules provided in the House bill.

Thus, as already noted earlier herein, the first rule expressly provides that companies on straight line depreciation are to continue to use that method of tax depreciation. The second rule provides that companies on liberalized depreciation with normalization may continue to use liberalized depreciation only if they continue also to use normalization; otherwise, they have to change to straight line depreciation. Finally, the third general rule requires companies on flow-through to continue to use that method *unless permitted to change to another method of tax depreciation by their regulatory agency.*

It is to be observed that each of these rules operates so as to bar any company from changing to a *faster* method of tax depreciation than that currently being used by that company. In other words, since tax revenue losses occur when a company changes to a faster method of tax depreciation, the effect of these restrictions built into the three rules against changing to faster methods of tax depreciation is to put a halt to any further increases in tax revenues losses which otherwise might have resulted.

Also, it is to be observed that the "freeze" was solely one-way in that, at the same time that it precludes changes to *faster* methods of tax depreciation, it does *not* preclude changes to *slower* methods. Thus, a company on liberalized depreciation with normalization

could shift to the slower straight line depreciation—but not to the faster flow-through. Likewise, companies on flow-through could, with agency permission, shift to the slower straight-line or normalization, whereas companies on straight-line—already on the slowest method of tax depreciation—are not permitted to change their method of tax depreciation, even with agency permission.[19]

3. The "Freeze" Built Into the Three General Rules Is the Congressional Solution to a Dilemma

This "freeze" *prohibiting changes to faster* methods of tax depreciation, *but not to slower* methods of tax depreciation constitutes the solution adopted by the House and Senate Committees to resolve the dilemma with which they regarded themselves as being confronted in this area.

On the one hand, both the House and Senate Committees involved were gravely concerned over the loss of tax revenues being suffered by the Federal Treasury as a result of the trend among the various Federal and State regulatory agencies to require the use of faster methods of tax depreciation. On the other hand, they were acutely aware that prohibiting regulated companies from using these faster methods of tax depreciation would in many instances adversely affect the competitive position of some of these companies. The three general rules constitute the answer adopted by the Committees to accommodate these conflicting considerations.

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[19] The American Public Gas Association opposed adoption of the three general rules, particularly the third rule expressly on the ground that they would operate to "inhibit the expanded use of accelerated depreciation and flow-through of the savings resulting therefrom for rate making purposes, * * *". See Hearings before the Senate Committee on Finance on H.R. 13270, 91st Cong., 1st Sess., Part 2, pp. 1387-1388; Part 6, pp. 6584-6585.

(a) *Congress Was Gravely Concerned Over the Substantial Tax Revenues Being Lost as a Result of the Use by Regulated Companies of Liberalized Depreciation and Flow-Through*

The reports of both the House and Senate Committees indicate that both Committees were gravely concerned over the trend among the regulatory agencies to require companies on straight-line to change to normalization and companies on normalization to change to flow-through (H. Rep. No. 91-413, *supra* at p. 132, App. A *infra* p. 78, S. Rep. No. 91-552, *supra* at 72 *infra* p. 81). Statistics submitted in the Hearings before the House Committee [20] indicated that the situation had reached the point that:

> "* * * utilities in 20 states must normalize; 17 must flow-through, and 13 state commissions have taken no action whatsoever. Meanwhile, the Federal Power Commission has ordered flow-through for both rate and accounting treatment. On the other hand, the Securities & Exchange Commission has taken no action on the rate treatment, but it will allow either normalization or flow-through in accounting. The Federal Communications Commission has also taken no action on rate treatment, except to say that the failure to use accelerated depreciation for taxes is considered in fixing the rate of return. On accounting treatment, the FCC has taken no action. The Civil Aeronautics Board has ordered normalization for rates [reserve de-

[20] Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess. on the subject of Tax Reform (hereinafter called "House Hearings"). It is interesting to note that the House Committees both heard extensive oral testimony and received written transmittals (see House Hearings, Part 10, pp. 3535, 3806, Part 11, pp. 3819-3969) whereas the Senate Committee heard no oral testimony and confined itself to limited written transmittals, the bulk of which is reproduced in the Hearings of the Senate Committee on Finance on H. R. 13290, 91st Cong., 1st Sess. Part 5, pp. 4963-4982.

ducted from rate base] and it has taken no action on the accounting treatment. The Interstate Commerce Commission has ordered flow-through for both rate and accounting treatment. Canada has ordered normalization for both." (See House Hearing at p. 3967-3968; see also pp. 3592, 3594, 3673).

The House and Senate Committees were concerned about the losses of tax revenues resulting from these trends toward the use of faster methods of tax depreciation since losses were already substantial (estimated to have reached $1.5 billion annually) and were threatening to become even greater if the trend were permitted to continue (House Hearings, *supra*, at p. 3884).[21] They were also concerned because one of their major responsibility was the recommendation of legislation to provide adequate revenues with which to operate the Federal Government and they felt very keenly that the greater the tax revenue losses in this area, the greater was the burden upon them to increase the tax revenues from other sources (*e.g.*, House Hearings, *supra*, at pp. 3567, 3753, 3884-5, 3871).

They were particularly upset about the tax revenue losses resulting from the increasing use of flow-through; in their view, not only were such revenue losses disproportionately great but they were unanticipated and inconsistent with the Congressional purpose in enacting the original legislation. The magnitude of the revenue losses resulting from the use of flow-

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[21] As stated in the House Committee Report (H. Rep. No. 91-413, *supra*, at p. 132):

"Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion: some estimates indicate that the loss might be considerably closer to $2 billion per year * * *". See also S. Rep. No. 91-552, *supra*, at p. 172.

through stemmed from the fact, summarized in the Senate Committee Report (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra* p. 81) that: "In general, flow-through to customers doubles the tax revenue loss involved in shifting from straight-line to accelerated depreciation." (See also, e.g., House hearings, *supra*, at pp. 3633, 3635, 3695-6). This doubling of the tax revenue losses came about by virtue of what is commonly called the "tax on tax" effect. In other words, this is so:

> "* * * because the current tax reduction reduces the rates charged to customers, which in turn reduces the utility's taxable income and therefore reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect. Assuming no other factors become involved, the total loss of taxes may be computed as the initial loss divided by the excess of 100 over the utility's marginal tax rate. At the present surcharge rates, the total tax loss is 212 percent of the initial loss; without the surcharge, the total loss is 192 percent of the initial loss." (H. Rep. No. 91-413, *supra*, at p. 132, App. A, *infra*., p. 78).

While this concern was shared by many of the members of the House Ways and Means Committee, perhaps the most vocal was Committee Chairman Mills.[22] For example, during the questioning of Mr. Van Scoyoc, a witness appearing on behalf of a number of consumer groups in opposition to any change in the *status quo*, (House Hearings, *supra*, at p. 3739-40), Chairman Mills commented, *inter alia* (House Hearings, *supra*, at pp. 3753-54):

> "The CHAIRMAN. What I am getting at is this: What would be wrong with a provision which says

[22] Chairman Mills, of course, was also a member of the Conference Committee. See H. Rep. No. 91-782, *supra*, at pp. 1, 346.

that if a commission, regulatory agency, State or Federal, is going to require a taxpayer, through ratemaking purposes, to go on a more rapid method of depreciation, that the Secretary of the Treasury has the authority to withdraw the privilege for tax purposes from the taxpayer and put him on straight line?

Maybe it is because of where I sit, but I do not like to have these agencies of Government establish a fiscal policy by doing away with provisions of tax law. Then to have us wake up one of these days to the fact that we are getting $1,500 million less revenue because of a decision with respect to the use of depreciation, made by some regulatory commission downtown or out in some State capital."

Why can't we arrange to give the Secretary of the Treasury, the caretaker of the Federal revenues under laws enacted by the Congress the authority to protect the Federal revenues?

* * * *

The CHAIRMAN. He is not going to regulate rates. He is not going to tell you what to do. He is just going to say, "I will not let you strip me bare of my revenues and use them for the purpose of subsidizing rates."

Subsequently, in discussing with Commissioner Morrissey of the California Public Utilities Commission, the action of that Commission in trying to force Pacific Telephone and Telegraph Company to change from straight line depreciation to liberalized depreciation with flow-through by fixing the tax allowed in its rate as if it had used flow-through, Chairman Mills further commented (House Hearings, *supra,* at pp. 3882-3884):

* * * *

"Certainly, you have thwarted the Federal policy, the will of the Congress, if you pass it through in

total to the consumers of the service of the utility. You are doing just as much of a wrong as we may have done in the beginning in establishing this policy.

* * * *

"How can we get out of this conflict of State and Federal goals? You want your rates to be as low as possible, and I want to have them, for the benefit of your consumers in California, as low as they should be. I don't want you, through this device, however, to take money from the Federal Treasury and to subsidize rates when we intended it as a subsidy of the business to create employment.

* * * *

"The CHAIRMAN. But you see the whole purpose of this hearing is to determine whether we want these so-called preferences, or as Mr. Madden called them this morning 'loopholes' or as somebody else said 'subsidies,' to continue.

The question here is whether we want the tax laws of the United States to divert from $125 to $150 million of what would otherwise be Federal revenue for the benefit of the consumers of utility services in California. * * *

At any rate, * * * * * * the question is whether we want our tax laws to be used to subsidize somebody.

Mr. MORRISSEY. I do not agree with the word subsidy in that respect.

The CHAIRMAN. What is it called when it goes to consumers as opposed to the oil company, the realtor or somebody else?

Mr. MORRISSEY. It is a reduction in taxes, sir, because the ratepayers and utilities are also the taxpayers.

The CHAIRMAN. We are not reducing the utility rates of people in California in this manner and we are not doing it in Arkansas, not as long as I

am chairman of the committee, my friend. I don't want it standing in the record that we voted in Congress to reduce the tax burdens of the people in California and in no other State in this manner.

I can assure you about that.

* * * *

"Mr. MORRISSEY. Sir, I would help you get out of this dilemma sir, by having the Arkansas Commission, I guess, go to flow through if the growth prospects for the utilities in Arkansas—

THE CHAIRMAN. They are great.

Mr. MORRISSEY. If that is so, then you should get your commissioners on the telephone.

The CHAIRMAN. That is not the kind of tax reduction my people are talking about. They never mentioned doing it this way. First of all they don't want the 10-percent surcharge extended. They would like to have that replaced by doubling the personal exemption, and a few other things, but they never write me about reducing their taxes by reducing their utility costs. Maybe that is an idea that just hasn't occurred to them.

Mr. MORRISSEY. I suggest to you to talk to them about it.

The CHAIRMAN. Do you mean to just leave this like it is?

Mr. MORRISSEY. Yes sir.

The CHAIRMAN. Do you know how much Federal revenue is that would be involved if we leave it like it is, if you and all these commissions force these people to flow through and everybody uses accelerated depreciation, but nobody gets the benefit except the consumer service? Do you know how much it amounts to?

Mr. MORRISSEY. I would suspect something like three-quarters of a billion dollars.

The CHAIRMAN. You are about half of the way there. It is $1.5 billion when extended across the board.

What you do, in your zeal to get a rate as low as you can get it, and I am not fussing about it because that is your responsibility, when you make a corporation elect to do something that it would not otherwise do because it reduces its tax payment that you can then use as a basis for lower cost of the service, you are requiring that company to pay less Federal tax at a time when we need so much more.

This comes when your Governor and other Governors are asking us to share revenues with them. I have offered to do it if they will let us share the Federal deficit with them. But you see, we are working at cross-purposes, I think."[22]

In light of these reactions by the members of the House Committee, it is easy to understand the comment in that Committee's report (H. Rep. No. 91-413, *supra*, at 132, App. A, *infra*, p. 78):

> "Your Committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow through is unacceptable at this time."

And the Senate Committee Report is to the same effect (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra*, p. 81):

> "In general, flow-through to customers doubles the tax revenue loss in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this item is unacceptable at this time."

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[22] For the reaction of other House Committee members on these problems, see House Hearings, *supra*, at pp. 3870-3899.

(b) *Congress Was Concerned that Withdrawal of Liberalized Depreciation Would Place Regulated Companies at Competitive Disadvantage*

Although, as just indicated, both the House and Senate Committees were strongly opposed to the continuation of the rate reductions or "subsidies" resulting from the flow through requirements of many of the regulatory agencies, they were also aware that it was impractical to do away entirely with the "subsidy". In this regard, it is noteworthy that the Federal Power Commission, which has long been the leader in requiring flow-through, advised the House Committee, through its Chairman, that in its view, the electric and natural gas utilities subject to its jurisdiction did not need the incentives intended to be provided by liberalized depreciation, and hence it recommended that liberalized depreciation be withdrawn from regulated companies so as "not to give them that subsidy, so to speak". (See House Hearings, *supra*, at p. 3567; see also pp. 3542, 3548, 3555).

However, the ICC, FCC, CAB, along with representatives of the electric utility industry, among others, opposed the withdrawal of liberalized depreciation as suggested by the Power Commission on the ground, *inter alia*, that it would place companies subject to regulation at competitive disadvantage with their non-regulated competitors. See House Hearings, *supra*, at pp. 3584, 3585, 3600, 3603, 3604, 3760. For example, the FCC urged (House Hearings, *supra*, at p. 3600):

> "We see no reason why the utility, simply because it is ordinarily not subject to competition, should not have the same opportunity, subject to proper

regulatory review, to employ rapid depreciation with the same options as Section 167 extends to unregulated business. In other words, under appropriate circumstance it may well be in the best interest of the utility and its customers for the benefits of accelerated depreciation to be applied for purposes other than the expansion of its plant capacity.

Moreover, there are many areas in which the regulated utility finds itself in a form of competition with the nonregulated sector. For example, in the field of communications, a nonregulated business can choose to construct and operate its own private microwave communications system, rather than meeting its communications requirements by lease from the regulated common carriers. Whether or not it will do so can turn largely on the economics of the choice. In this context, a decisive difference in cost could result if tax savings from rapid depreciation of the privately-owned microwave facilities were available to the unregulated business, but would be denied to the common carriers if the FPC proposal were to be adopted. Under such circumstances the common carrier would be at a disadvantage in competing for the communications business of the unregulated sector solely because of the change in tax policy."

That both Committees were concerned with the dilemma created by these conflicting objectives is apparent from their respective reports. Thus the House Committee, after noting that the substantial revenue losses resulting from the use by the regulated industries of liberalized depreciation and flow-through was "unacceptable", goes on to comment (H. Rep. No. 91-413, *supra*, at 132, App. A, *infra*, pp. 78-79):

"Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too

many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors.* * * "

Similarly, the Senate Committee, after likewise noting that such revenue losses were "unacceptable", went on to point out (S. Rep. No. 91-552, *supra*, at p. 172, App. B, *infra*, p. 82):

> "On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation."

(c) ***The "Freeze" Built Into the Three General Rules Not Only Forestalls Additional Revenue Losses and Prevents Impairment of the Competitive Position of Regulated Companies, But Leaves the Way Open for Reduction of the Revenue Losses.***

The Committee apparently found an acceptable resolution of the dilemma created by the competing objectives in the three general rules. On the one hand, the "freeze" against changing to *faster* methods of tax depreciation built into these rules in effect serves to halt the trend in that direction and thereby to prevent any increases in the loss of tax revenues. On the other hand, by not disturbing a utility's present method of tax depreciation and leaving the way open for it to change to

a slower method, the three rules provide the leeway needed to protect the competitive position of the regulated companies needing such protection, while at the same time keeping the way open for reductions in the revenue losses through changes, where appropriate, to slower methods of tax depreciation. As noted *supra*, both the House and Senate estimated that the effect of the amendments would result in revenue increases of "60 million in 1970, $260 million in 1974 and $310 million in 1979." H. Rep. No. 91-413, *supra*, at 134, App. A., *infra*, p. 80; S. Rep. No. 91-552, *supra*, at 176, App. B., *infra*, p. 89.

In contrast, the Court's version of the Congressional resolution of this dilemma has a number of fatal infirmities. To be sure, under the Court's version, there would be a halt to any increase in the tax revenue losses and the competitive position of regulated companies would not be impaired. But, the Court's view that companies on flow-through are frozen to that method would be unfair to such companies since under the second general rule companies on liberalized depreciation with normalization would be permitted to change to the slower straight-line method of tax depreciation. More particularly it would be contrary to the fulfillment of any Congressional purpose, since flow-through is the fastest method of tax depreciation and represents the greatest tax revenue loss to the Treasury. In addition, a "freeze" on liberalized depreciation with flow-through would destroy the flexibility and ability to accommodate to changing conditions, for example, when the "crossover point"[24] is

[24] Under Section 167(e)(1) of the Internal Revenue Code, any taxpayer, using the double-declining balance method, may at any time elect to revert to a straight-line method over the remaining life of the property involved to recover the undepreciated portion

reached and the public interest is better served by changing from flow-through to other methods of tax depreciation.

And, finally, it would frustrate the Congressional purpose. Not only would it prevent the reduction in the tax revenue losses which would come about when such a company changes to a slower method of tax depreciation, but it would prepetuate the very type of tax revenue loss which the Act's legislative history so plainly discloses was obnoxious to many of the responsible members of Congress.

B. Congress Recognized That Rate Increases Would Be Necessary To Reflect Changes To Slower Methods of Tax Depreciation

In further support of its reading of Section 441, the Court below (FPC Pet. 35-36) quotes from a Summary of the Bill prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance to the effect:

> "The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws,

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thereof. This right was provided in order to enable the taxpayer to maximize his tax depreciation deduction and, consequently, to minimize his tax when the reversion to a straight-line method would provide greater tax deductions than would the continuation of the double-declining balance method. This point is definitely ascertainable and all would agree that it is in the public interest and prudent for the utility to revert to a straight-line method at this point of time which is commonly called the "crossover" point. Yet, as indicated above, the decision of the court below would preclude the utility taxpayer from shifting to a straight-line method thereby depriving the utility and its customers from the benefits of this reduction in taxes and consequent reduction in cost of service.

since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.[23]

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[23] "Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, at 73."

In relying on this excerpt, the Court below adopts, in effect, the claims advanced by respondent Memphis (Br. in Opp. pp. 3, 4, 6) that the practical effect of the Commission's interpretation "* * * is to necessitate present rate increases by practically all of the interstate natural gas pipelines as well as many other regulated utilities in the country", and that such a result is contrary to the express purposes of Congress, manifested, again according to Memphis, in the statements in the House and Senate Committee Reports relative to the "freeze", quoted *supra* at p. 37.

But, as is apparent from discussions relative to the "freeze", neither of the references thereto in the House and Senate Committe reports indicates an intent, on the part of these Committees, to avoid utility rate increases. To the contrary, the comments of Chairman Mills set out, *supra*, pp. 44-48 strongly indicate that while he was opposed to widespread rate increases because of their potential disruptive effect, the rate reductions which had in the past resulted from the use of the flow-through had themselves been unwarranted and contrary to the Congressional purposes. Consequently, in his view, the rate increases appropriate to reflect elimination of flow-through would in reality merely serve to eliminate an unwarranted subsidy and to restore rates to the level at which they should have been originally.

Memphis further argues (Br. in Opp., pp. 5, 7), that such rate increases would be at odds with (1) the House Committee's rejection of the FPC's suggestion to require all regulated utilities to change to straight-line depreciation because it "would result in prompt, substantial and widespread utility rate increases" (H. Rep. 91-413, *supra*, at p. 132, App. A, *infra*, p. 79) and (2) the above statement from the Summary by the Joint Committee Staff, which Memphis quotes as support for the argument that:

> "When the bill was molded into its final form, the Congress was still of the firm impression that it had avoided any widespread substantial utility rate increases." (Memphis Br. in Opp., p. 7).

However, these additional references likewise do not support the conclusion urged by Memphis and adopted by the Court below. To begin with, it should be noted that the House bill contained the three general rules and the Court below expressly recognized that "the Commission's and Texas Gas' position here [was] clearly justified" had the House bill been enacted. See *supra*, p. 15. But that's really beside the point since, in addition, the statement in the House Committee report was directed to an entirely different situation from that provided in the bill as enacted. Even if the Commission action taken here were to result in rate increases for wholesale gas and electric companies generally, the increases involved would be substantially less than those indicated under the Power Commission's suggestion since that suggestion would have imposed an *obligation* to change to straight-line depreciation whereas the Commission action here merely *permits* a change and then only to liberalized depreciation with normalization. And since, as suggested by both Committees (H. Rep. No. 91-413, *supra* at 133, App. A, *infra* p. 80;

S. Rep. No. 91-552, *supra*, at p. 173, App. B, *infra*, p. 83), the Commission excludes from rate base, upon which a return is computed, the special reserve reflecting the difference between taxes due and taxes allowed (Ref. R. 111) the rates under normalization patently are lower than under straight-line depreciation.

In addition, such increases would be substantially more limited in extent than indicated by the House Committee's comment, since the increases would involve primarily the wholesale gas and electric industries whereas adoption of the FPC proposal would have involved rate increases in all of the several additional regulated industries covered by Section 441.[25] As pointed out earlier, however, the testimony at the House Hearings indicated that many of the companies in the other industries covered by Section 441 would not be in a position to change to a slower method of tax depreciation and so they would not need compensatory rate increases.

In any case, it should be noted that while the Committees did not expect the widespread rate increases which would have resulted had the FPC suggestion been adopted, they did expect that adoption of the three rules would result in increases of tax revenues (which in turn would result from rate increases). See *infra* p. 58; see also H. Rep. No. 91-451, *supra* at p. 134; App. A, *infra* p. 80; S. Rep. No. 91-552, *supra*, at p. 176; App. B, *infra*, p. 89. Rate increases such as

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[25] Section 441 in terms applies to all properties used predominantly in the trade or business of the furnishing or sale of

(a) electrical energy, water or sewage disposal services;

(b) steam or gas through local distribution systems;

(c) telephone services and other communication services if furnished or sold by Comsat; and

(d) transportation of gas or steam by pipeline.

those claimed by Memphis with respect to the wholesale gas and electric industries are well within the range of increases contemplated at the House Committee hearings.

Thus, during these hearings, Congressman Byrnes first asked Chairman White of the Federal Power Commission as to the rate effect of a general repeal of liberalized depreciation and received the following answer (House Hearings, *supra*, at p. 3568):

> "Mr. BYRNES. If we repealed the accelerated depreciation provisions as they relate to utilities, it would require a new round of rate changes, wouldn't it?
>
> Mr. WHITE. In all likelihood.
>
> Mr. BYRNES. They would have to come to you to get permission to raise their rates. I assume they can reduce their rates without coming to you, can't they?
>
> Mr. WHITE. No, that too comes to us although it gets filed with us and hardly anybody ever excepts to it.
>
> Mr. BYRNES. It isn't seriously contested.
>
> Mr. WHITE. It isn't a serious problem to us, unlike some of my colleagues at the table here who do have that problem.
>
> Mr. BYRNES. But repeal of the accelerated depreciation provisions would entail quite a general round of rate negotiations or rate hearings and determinations?"
>
> Mr. WHITE. Yes, sir."[26]

At this point, Chairman Mills interjected by postulating a modified but less far-reaching revision than

[26] The answer by Mr. White apparently became the basis for the comment in the House Committee report relied on by Memphis.

that proposed by the Power Commission (House Hearings, *supra*, at pp. 3568-9):

> "The CHAIRMAN. Would it if we did it this way, Mr. Chairman?
>
> By our permitting a continuation of the accelerated method with respect to assets previously acquired, but with respect to assets acquired after a certain date require then the straight-line method of determining depreciation?
>
> Mr. WHITE. In that case the problem would be far simpler but there would still, I must state, be a very strong likelihood that the utilities which would then lose the benefit of those tax reductions, tax savings, would feel obliged to go to their regulatory agency and say, 'Now that this decision has been reached by the Congress and we no longer again can take advantage of liberalized depreciation we must therefore get enough money somewhere and we need a rate increase.'
>
> So there will be some.
>
> The CHAIRMAN. They would be slower in coming.
>
> Mr. WHITE. It would be much slower, that is correct."

Note for future reference that Mr. White's response pointed out that once the utilities lose the benefits of the tax reductions with respect to new properties, they very probably would need rate increases to offset the loss of these benefits.

And in response to further inquiry by Congressman Byrnes, Mr. White indicated that permitting each utility to make its choice would be even "less disruptive" (House Hearings, *supra*, at p. 3569):

> "Mr. BYRNES. I think we must ask whether we are going to move into a situation where action by

this committee forces a rash of additional rate adjustments. I wonder whether we could avoid that by using the alternative of simply saying that the utility can make its choice. A regulated utility that has been on accelerated depreciation but wants to move back could do so, knowing also that it will then become involved in a rate change.

This wouldn't involve all utilities. They would probably look to see whether the change is enough to suggest the need to come in for an increase in rates or enough to suggest that they shouldn't change back. At least those that are still on the straight line could stay on the straight line. Wouldn't that be less disruptive than to simply repeal the accelerated depreciation provision for utilities?

MR. WHITE. Yes, certainly it would be much less disruptive. But I think on the basis of the bill that is before the committee if the committee is to take that course of action, it must be I think very mindful of what it tells the regulatory agency to do with respect to those who do not go back to normalization or to straight line."

The bill as proposed by the House Committee would have left the choice in the first instance up to the regulated utility whether to change to a slower method of depreciation and hence would have been much "less disruptive" as far as rate increase filings are concerned. Thus, that bill permitted changes in the methods of tax depreciation only in accordance with the three general rules and, as pointed out earlier, these rules contemplated no change in tax depreciation for companies on straight-line and changes in tax depreciation by companies on normalization or flow-through to a slower method only on an individual basis and then only with the permission of the regulatory agency. By thus restricting the ability of a regulated company on

normalization or flow-through to change to a slower method of tax depreciation, the bill as proposed by the House would probably have resulted in relatively few rate increase filings. In other words, as stated in the Summary of the Staff of the Joint Committee, referred to by both the Court below and Memphis, had the bill as proposed by the House been enacted there would have been "(with very few exceptions) * * *no increase in utility rates."

This brings us to the error of both the Court below and Memphis in placing such heavy emphasis upon this Summary by the Staff of the Joint Committee. Contrary to the understanding of the Court below and the implicit representation by Memphis, this Summary reflects not the "bill [as] molded into its final form" (Memphis Br. in Opp., p. 7), but rather the bill "as passed by the House of Representatives". Not only does the latter appear in the inscription on the cover of that document, but the Summary itself bears the date of August 18, 1969 and is reproduced in the Part 1 of the Senate hearings on the bill which commenced on September 4, 1969—both well before the enactment of the final bill on December 30, 1969. See Hearings before Senate Committee on Finance on the Tax Reform Act of 1969, 91st Cong., 1st Session, p. 7, *et seq.*, including particularly, p. 85.

As is evident from the discussion earlier in this brief, the bill as passed by the House of Representatives was *not* the one passed by the Senate or the one enacted into law. Instead, the Senate bill granted to companies on flow-through a limited right of election in addition to the third rule with respect to existing and new properties and the bill, as it emerged from conference and finally enacted, contained that additional right of election limited, however, to only new expansion proper-

ties. The rate increase here involved, stems basically from Texas Gas' exercise of that right of election. As found by the Commission, the effect of Texas Gas' exercising that right of election with respect to its new expansion properties, was to do away with the tax savings needed to avoid the future repayment of taxes avoided earlier by utilizing liberalized depreciation; and, accordingly, the Commission concluded that it would be contrary to the public interest not to permit Texas Gas to change to normalization with respect to its existing and new non-expansion properties.[37] In other words, the rate increases which Memphis claims would result from the Commission's ruling herein would stem basically from the operation of the additional right of election, which were not part of the bill as passed by the House. In addition, these increases clearly come within the parameters of the answer given by Mr. White in his response to Chairman Mills' question on rate increases (*supra*, pp. 57-58)—since, as found by the Commission, the exercise of the right of election operates to wipe out the "benefits of tax reduction, tax savings" with respect to expansion properties, the companies would very probably need rate increases to offset the loss of these benefits.

Significantly, neither the Senate Committee report, the Conference Committee report, nor the later General Explanation of the Tax Reform Act prepared by the Staff of the Joint Committee on Internal Revenue Taxation (dated December 3, 1970) contains even a comment about widespread rate increases resulting from adoption of the FPC suggestion, much less any

[37] We show below in Part III that that Commission finding is supported by adequate evidence in the record and is in the public interest.

suggestion that the treatment of tax depreciation for regulated utilities proposed in the bill under discussion would not result in rate increase filings. To the contrary, the Senate Committee report (at p. 176) indicates that its revisions of the House bill in providing a special election would result in increases, in an unknown amount, in the tax revenues over and above the increases projected in the House and Senate Committee Reports related to the three general rules:

> "*Revenue effect.*—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election."

III. THE COMMISSION'S ACTION IN PERMITTING TEXAS GAS TO CHANGE TO NORMALIZATION FOR ITS EXISTING PROPERTIES WAS WELL WITHIN ITS DISCRETION

Once it is recognized that Congress did not intend Section 441 of the 1969 Tax Reform Act to withdraw authority from the Commission to permit companies subject to its jurisdiction to change from flow-through to other methods of tax depreciation with respect to their existing properties, the only possible remaining question might be: whether the Commission properly exercised its discretion in permitting Texas Gas to change from flow-through to normalization for its existing properties?[28] As we show below, the Commission's action was well within such discretion.

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[28] See fn. 8, p. 14, *supra*.

A. The Choice of Method of Tax Depreciation Is Generally a Matter for Commission Discretion

The past cases dealing with Commission rulings with respect to the appropriate tax depreciation method to be used for rate-making, as well as accounting, purposes have uniformly affirmed such rulings as matters committed to the Commission's expertise and discretion.

Such, for example, was the holding of the Fourth Circuit in *City of Lexington* v. *F.P.C.*, 295 F.2d 109, 114 (1961) in affirming the approach originally adopted by the Commission that companies subject to its jurisdiction should be permitted to normalize, for rate purposes, the Federal income taxes allowed in their cost of service. At that time, the Commission had taken the view that the use of liberalized depreciation resulted in a tax deferral and, accordingly, in order to prevent the present rate payers from benefitting at the expense of the future rate payees and *vice versa*, the Commission directed that the difference between the income tax allowed and the actual taxes paid under that method of tax depreciation should be kept in a special restricted reserve account to be available, as needed, to pay the higher taxes of later years. See, e.g., *Amere-Gas Utilities Co.*, 15 F.P.C. 760, 781 (1956). In affirming that Commission ruling, the Fourth Circuit noted the variety of views on this subject among the courts and among the Federal and State Commissions (295 F.2d at 114) and concluded (*Id.* at 124):

> "It is obvious that we are confronted in this case with a problem in a special field which requires the exercise of expert skill that has been generally entrusted to administrative tribunals whose deci-

sions in the absence of abuse of discretion should be followed by the courts."[29]

Subsequently, when the Commission, in a reversal of its earlier position, found that the use of liberalized depreciation generally resulted in a permanent tax savings and directed that these "savings" be flowed-through to the customers in the form of reduced rates, the Fifth Circuit's affirmance similarly stressed the Commission's expertise and absence of abuse of discretion. See *Alabama-Tennessee Natural Gas Co.* v. *F.P.C.*, 359 F.2d 318 (5th Cir. 1966) *cert. denied*, 385 U.S. 847 (1966). Pointing to the Commission's reasoning that the natural gas industry was a growing, or at least a stable, industry and hence, according to the Commission, the use of normalization resulted in a tax savings rather than a tax deferral, the Court concluded (359 F.2d at 339):

> "In final analysis, putting to one side the issue of Congressional intent, the petitioners' challenge to the FPC order addresses itself to the competency of the Commission to choose between competing accounting theories and competing economic guesses. We see nothing irrational in the Commission's choice."

Similarly, the Solicitor General stressed the discretionary nature of such Commission actions in opposing certiorari on behalf of the Federal Power Commission in the *Alabama-Tennessee* case (FPC Br. in Opposition in No. 286, Oct. Term, 1966 at pp. 7-8):

> "The question of the appropriate treatment for rate-regulation purposes of tax reductions result-

[29] See, also *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F.2d 567, 573 (5th Cir. 1960), *cert. denied, sub nom., California* v. *F.P.C.*, 366 U.S. 912 (1961).

ing from the use of the liberalized depreciation method is, concededly, a recurring one of general interest and importance in the regulatory community; and the present case represents a change in the thinking of the Federal Power Commission on the subject. Nevertheless, we do not think that the case calls for further review by this Court. The issue of flow-through v. normalization is basically one for resolution through the exercise of administrative discretion. When certiorari was sought in 1961 by the State of California, in the *El Paso* case, to review the Commission's earlier choice of normalization over flow-through, we stated:

> '* * * Such a choice is not one which warrants review by this Court. Under the same principle, the choice is one which can be changed by the Commission should it become convinced the other method is preferable. * * * [*California* v. *Federal Power Commission*, 366 U.S. 912, O.T. 1960, No. 599, Brief in Opposition for Federal Power Commission, pp. 11-12]'."[30]

B. The Changed Circumstances Fully Justified the Commission's Refusal To Require Continuation of Flow Through

In permitting Texas Gas to change from flow-through to normalization with respect to its existing properties, the Commission emphasized that the circumstances had changed drastically, since it had rendered its decision in *Alabama-Tennessee*. Accordingly, it concluded it would not be appropriate to require Texas Gas to remain on flow-through. Such conclusion, we submit, was entirely justified.

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[30] See, also, *City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967) *cert. denied, sub nom. P.S.C. of Wisconsin* v. *F.P.C.*, 390 U.S. 945 (1968); *Midwestern Gas Transmission Co.* v. *F.P.C.*, 388 F.2d 444 (7th Cir. 1968) *cert. denied*, 392 U.S. 928 (1968).

1. A Critical Shortage of Natural Gas Has Developed Since Alabama-Tennessee

As pointed out in its Opinion herein (R. 107), the Commission in *Alabama-Tennessee* had

> "based [its] conclusions on [its] finding that liberalized depreciation would exceed straight-line depreciation where the company continues to make capital additions. Even where the composite plant of a company remains stable, we found, annual liberalized depreciation would not be lower than straight-line depreciation. Thus we concluded that a regulated utility would never be required to pay higher income taxes because of its election to claim liberalized depreciation unless its gross plant declines in dollar value as a result of lower demand or lower plant construction costs."

In so concluding in *Alabama-Tennessee,* the Commission found with respect to gas supply (31 F.P.C. 208 at 218):

> "We do not dispute the contention that economically extractable gas reserves will suffer exhaustion at some indeterminate future date. However, we know of no reliable claim that such exhaustion of gas supplies is certain or even probable within this century. The fact that our gas reserves may be exhausted in the 21st century certainly does not establish that there is a present need for additional normalization."

And with respect to future industry growth and investment in plant, the Commission had stated in *Alabama-Tennessee* (*Id.* at 217-218):

> "Almost all responsible forecasts reflect the widespread belief that the gas pipeline industry will continue to expand at least until 1980 * * * A recent report by the National Fuels and Energy Study group to the Senate Committee on Interior and Insular Affairs, * * * concluded (at p. 37 of

the Report) that the use of gas in 1980 will be somewhat less than doubled the 1960 usage and observed that the majority of the pertinent estimates clustered in the range between 20 and 23 trillion cubic feet. * * * Although these estimates relate to gas consumption rather than to the capacity of gas pipeline plant, it is fair to infer that an approximate doubling of sales will generate a roughly proportional increase in plant investment."

The situation today is dramatically different from that which the Commission envisioned when it issued its opinion in *Alabama-Tennessee*. Referring to the portions of the Commission's decision in *Alabama-Tennessee* quoted above, Mr. W. M. Elmer, Chairman of the Board of Texas Gas and its chief executive officer commented at the hearings in the instant case (R. 4):

> "Today, * * *, the entire industry is faced with a very serious problem relating to the availability of natural gas reserves with respect to the expansion of service as well as service to existing markets. I feel that, with the assistance of the Federal Power Commission in its price fixing policies, the gas shortage problem can be alleviated.
>
> "On the other hand, I am also convinced that the problems involved in acquiring and providing long-term gas supply, on an economical basis, are much more serious today than existed at the time of the Alabama-Tennessee decision."

The natural gas shortage thus adverted to by Mr. Elmer has become even more acute since the close of the administrative record in *Alabama-Tennessee* and has become the subject of widespread public and judicial notice. See, *e.g.*, *F.P.C.* v. *Louisiana Power and Light Co.*, 406 U.S. 621 (1972); *Southern Louisiana Area Rate Cases* v. *F.P.C.*, 428 F.2d 407, 434-444 (5th

Cir. 1970), *cert. denied, sub nom. Municipal Distributors Group* v. *F.P.C.*, 400 U.S. 950 (1970); *City of Chicago* v. *F.P.C.*, 458 F.2d 731 (D.C. Cir., 1971), *cert. denied*, 405 U.S. 1074 (1972); *New York Public Service Commission* v. *F.P.C.*, 467 F.2d 361 (D.C. Cir. 1972). Indeed, in a "Notice of Proposed Policy Statement with Request for Comments" issued in FPC Docket No. R-467, on January 8, 1973, while this brief was being prepared, the Commission undertook to prescribe the establishment of priorities in the use of natural gas because, in part (*mimeo.*, p. 4):

> "Available data indicate that not all jurisdictional pipelines have been able to procure contracts for new supplies of gas in sufficient quantities to insure that all present and potential customers of natural gas will be able to receive an adequate supply in the foreseeable future. Interstate pipelines, in many instances, have been unable to provide additional service to existing customers or service to new customers and some major interstate pipelines are at the present time being forced to curtail deliveries of natural gas below existing contractual commitments.
>
> "Supply shortages may not be eliminated in the immediate future. The recent report on 'National Gas Supply and Demand 1971-1990, Staff Report No. 2', prepared by the Commission's Bureau of Natural Gas projects that the level of potential but unsatisfied demand for gas will rise to 17 trillion cubic feet by 1990. The staff estimates that between 1970 and 1990 accumulated potential demand will exceed projected supplies by more than 185 trillion cubic feet. Additionally, the Future Requirements Committee (FRC) estimates that (exclusive of field use) potential natural gas demand in the United States will increase from about 23.3 trillion cubic feet in 1971 to 28.5 trillion cubic feet in 1975. Based on this projection and on infor-

mation concerning presently contracted or reasonably assured supplies, the FRC estimates that the gap between potential demand and reasonably assured supplies will increase from about 1 trillion cubic feet in 1971 to nearly 4 trillion cubic feet in 1975. *Future Gas Requirements of the United States,* Future Requirements Committee, Vol. No. 4, October 1971, page 3."

2. Texas Gas' Exercise of the Election to Shift to Normalization for Its New Expansion Properties Destroys the Basis for the Commission's Finding That Liberalized Depreciation Results in Tax Savings

In addition to the above dramatic change in the supply picture since the Commission's decision in *Alabama-Tennessee,* the Commission further found that Texas Gas' change to normalization with respect to its new expansion facilities, as permitted under the election, had the effect of rendering tax depreciation on these new facilities no longer available to offset the declining tax depreciation on the older facilities as contemplated in *Alabama-Tennessee.* Accordingly, the Commission concluded—and, we submit, properly so—that the continued use of liberalized depreciation with respect to Texas Gas' older properties would no longer result in tax savings (R. 108).

To be sure, as Memphis urged in the Court below, even with the election, Texas Gas' new productive facilities will still be subject to liberalized depreciation, just as they were before. However, it does not follow therefrom, as Memphis further contended, that the tax depreciation on such facilities will be "available" to Texas Gas to offset the decreasing tax depreciation on the old properties. What Memphis overlooks in making the argument is that under normalization, the difference between the taxes which would be payable under straight-line depreciation and those which are payable under liberalized depreciation is placed in a

specially restricted reserve (Account No. 282).[31] These funds are not available to offset the increasing taxes which are associated with facilities subject to the flow-through method and which result from the declining depreciation deductions as these facilities grow older. The increasing taxes are an expense, and as such, must be offset by income. However, the difference in tax between straight-line depreciation and liberalized depreciation, under normalization, is a charge against income, and therefore, is no longer available to offset the increased tax expenses.

Nor is there any merit to Memphis' argument that, in light of the inflationary spiral, Texas Gas' replacement of existing plant will necessarily reflect a higher investment cost, and thus, that the resulting higher depreciation expense therefor will still mean a tax saving relative to existing and replacement plant even excluding the new expansion facilities. Whatever may be the validity of this argument in the abstract,[32] the argu-

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[31] Under normalization accounting, the difference in taxes on income which are payable because of the use of liberalized depreciation in computing such taxes, as compared to the taxes payable using the depreciation deduction otherwise appropriate and allowable for tax purposes, is credited to Account No. 282 of the Commission's Uniform System of Accounts entitled "Accumulated Deferred Income Taxes—Liberalized Depreciation". Account No. 282 is a reserve for deferred taxes. The utility is restricted in its use of this account. For example, it cannot transfer the balance in the account, or any portion thereof, to surplus or make any use thereof except as specifically provided in the text of the account without prior approval of the Commission. This reserve cannot be used for the payment of dividends or distributed, in any form, to the stockholders, and hence, unlike profits or return, it is not available to the investors.

[32] There is no evidence in the record to support Memphis' position either as to the industry, in general, or with respect to Texas Gas, in particular.

ment does not conform to the facts with regard to Texas Gas. The record shows that, in order to offset the decline in tax depreciation under liberalized depreciation, between 1970 to 1971 Texas Gas would be required to install facilities having a cost of approximately $33,000,000 (R. 17). Based on past experience, there is no possibility of Texas Gas' installing replacement facilities of that magnitude in that period. The plant retirements of Texas Gas for the last fifteen (15) years as reflected in its Annual Reports to the Federal Power Commission (FPC Form No. 2) were:

Year	Annual Plant Retirements	Year	Annual Plant Retirements
1955	$ 981,966	1963	$2,776,415
1956	971,897	1964	1,416,271
1957	1,645,303	1965	1,548,729
1958	1,077,071	1966	1,864,482
1959	927,060	1967	5,262,854
1960	1,169,307	1968	2,652,179
1961	2,026,882	1969	1,937,694
1962	979,429		

Even assuming that all retirements had to be replaced—which is highly unlikely—it is perfectly evident that the amounts expended to replace such property, even at inflated price levels, would fall far short of the $33,000,000 required to offset the loss in tax depreciation between 1970 and 1971.

Finally, contrary to Memphis' claim, no evidence was needed to support the Commission's reference to the fact that the physical life of natural gas properties is much longer than economic tax depreciation life. Since the latter is dependent upon gas supply, it has

long been recognized that the physical life of natural gas transmission facilities far exceeds their economic life. Since at least the Commission decision in *City of Detroit* v. *Panhandle Eastern Pipe Line Co.*, 3 FPC 273, 282 (1942), *affirmed, sub nom, Panhandle Eastern Pipe Line Co.*, v. *F.P.C.*, 143 F.2d 488 (8th Cir., 1944), *affirmed*, 324 U.S. 635 (1944), it has been generally accepted that the economic life of natural gas transmission properties are "governed by such elements of depreciation as the exhaustion of the natural gas supply, wear, decay, inadequacy and obsolescence" and that the provision for depreciation should be "sufficient to provide for the restoration of the capital investment over the life of the gas supply." 3 FPC at 282. See also, *Canadian River Gas Co.*, 3 FPC 32, 46-52 (1942), *affirmed*, 142 F.2d 943 (10th Cir., 1944), *affirmed sub nom Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581 (1945); *Interstate Natural Gas Co.*, 3 FPC 416, 422-425 (1943), *petition for review denied*, 156 F.2d 949 (5th Cir., 1946), *affirmed*, 331 U.S. 682 (1947); *United Fuel Gas Co.*, 12 FPC 251, 265-266 (1953); *Olin Gas Transmission Corp.*, 17 FPC 685, 688-690 (1956); *United Carbon Co.*, 25 FPC 181, 184-186 (1961). Indeed, in accordance with this principle, the Commission has recently permitted United Gas Pipeline Company to increase its 2.88% depreciation rate to 5.00% (*United Gas Pipe Line Co.*, FPC Opinion No. 645, issued January 11, 1973, Mimeo., pp. 10, 11):

> "United has clearly shown * * * that its current reserve life index is substantially below its life index at the time the 2.88% depreciation rates were established. It has also shown that this index has declined sharply since 1948 almost without

interruption. On the basis that the current gas shortage and United's critically low reserve life index will not allow United to expand sales in the future as it has in the past, will probably force it to utilize much of its property at less than its full capacity, and could force it to abandon some of its property prematurely, we find it prudent and in the public interest to allow United to utilize a rate of depreciation which reflects the undeniable change in United's gas supply which has occurred since the currently effective rate of 2.88% was established in 1943."

C. The Commission Findings That Normalization Would Be Beneficial Are Supported by Substantial Evidence

1. The Commission Properly Found That Normalization Would Help Stabilize Rates

As further support for its conclusion, the Commission also found that permitting Texas Gas to change to normalization would help stabilize Texas Gas' rates (R. 109). Contrary to Memphis' argument before the Court below, this finding is supported by substantial evidence.

Texas Gas' witness Meythaler testified, during cross-examination by Memphis' Counsel Morrow, that liberalized depreciation with normalization would provide for stability of rates (R. 34-35):

"Q. I recognize we may be participating in an exercise in futility if the law changes. But by returning to 1966, what you simply mean is going back to the straight-line method of depreciation?

"A. No, I would say we ought to be back to normalization and taking liberalized depreciation, and then we would have a little more chance of stability of rates.

"Q. Yes, because then in that case you would be then taking more tax dollars from your customers than you had to pay to the Government, wouldn't you?

"A. Oh, absolutely. We did not pay the taxes, no. They were deferred taxes, right. And we would have the use of them, correct. And that would give us an ability to maintain more of a semblance of stability of rates than we are faced with today under this practice."

Witness Meythaler also testified at some length with respect to the fact that straight-line depreciation would provide greater stability of rates than flow-through (R. 29-30, Exh. No. 33, R. 46). Exhibit No. 33 and Witness Meythaler's testimony show that, under straight-line depreciation, Texas Gas would have the ability to absorb more than $1,000,000 of increased costs in each of the years 1970 through 1974, or a total of $5,304,000. There would be a similar effect under normalization. In contrast, under liberalized depreciation with flow-through, the company's ability to absorb increased costs each year ranges from $193,000 to $558,000, or only $1,875,000 during the same five year period.

2. The Evidence Shows That Normalization Will Enhance the Quality of Texas Gas' Securities

Similarly supported is the Commission's additional finding in this regard (R. 109) that the use of normalization will improve Texas Gas' before-tax coverage of interest, thereby enhancing the quality of its securities. The revenues from a rate based on normalization are greater than the comparable revenues based on flow-

through by the amount that goes into the reserve in that year under normalization plus the tax thereon. In other words, under normalization, there is included in the rate a dollar for taxes for every dollar that goes into the reserve. Since both the reserve dollar and the tax dollar thus included in the normalization rate are available for the company's before-tax bond coverage, it is apparent that the Commission's finding in this regard is on sound ground.

Memphis sought in the Court below to belittle this finding by arguing that "after-tax" coverage is more important than "before-tax" coverage because taxes have a priority in bankruptcy. But the fact is that since interest is an expense which is payable whether or not there are any earnings and hence it is payable whether or not there is any tax liability, the "before-tax" coverage is patently a matter of primary concern to investors. As summarized by Texas Gas' witness Meythaler (R. 39):

> "Presiding Examiner: The witness' only point is if your interest uses up your income you have no tax. Isn't that—
>
> "Mr. Boland: That's right.
>
> "Presiding Examiner: It is as simple as that, isn't it, Mr. Meythaler?
>
> "The Witness. Yes, sir. It is just a matter of what would you look at from an investor standpoint for protection or ability to pay the interest obligation. And the more dollars you have, the better off you are. And you know that you come in ahead of Uncle Sam, because interest is a deduction."

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals should be reversed with directions to affirm the Commission's Opinions No. 578 and 578-A.

Respectfully submitted,

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APPENDIX A

Pertinent Provisions of Report of House Committee on Ways and Means on Tax Reform Act of 1969, House Report No. 91-413, Part I, 91st Cong., 1st Session

[131] B. DEPRECIATION ALLOWED REGULATED INDUSTRIES

1. Accelerated Depreciation (sec. 451 of the bill and sec. 167 of the code).

Present law.—Under present law, regulated industries are permitted the same elections regarding depreciation of their business properties as are other taxpayers. About half the regulatory agencies re- [132] quire utilities that use accelerated depreciation for tax purposes to "flow through" the resulting reduction in Federal income taxes currently to the utilities' customers. Other agencies permit the utilities they regulate to "normalize" (as described below) the deferred tax liabilities resulting from accelerated depreciation. Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes; even if those utilities use straight line depreciation for tax purposes, such agencies treat them for ratemaking purposes as though they had reduced their Federal income tax expense by using accelerated depreciation.

General reasons for change.—The trend of recent years has been that regulated utilities previously on straight line depreciation have been shifting to various forms of accelerated depreciation. At the same time, regulatory agencies which had previously permitted the tax deferrals resulting from accelerated depreciation to be "normalized" (computing the greater Federal income tax liability that would have resulted from use of straight line depreciation and adding this amount to a reserve account for future tax liability on the regulated utility's books of account), have been shifting toward requiring the flowing through to customers currently of the tax deferrals resulting from the

use of accelerated depreciation. Finally, within the past 12 months several agencies have imputed accelerated depreciation in determining the Federal tax expense of the utilities, and flowed through the resultant tax deferrals, even though the particular utilities involved were in fact using straight line depreciation and in fact were paying the greater current Federal income taxes resulting from the use of that method of depreciation.

In general, flowing through the tax deferral to the customers of a utility that is already earning its maximum permissible profit on its investment, results in a doubling of the Government's loss of revenue from the use of accelerated methods of depreciation for tax purposes. This is because the current tax reduction reduces the rates charged to customers, which in turn reduces the utility's taxable income and therefore reduces its income tax. This second level of tax reduction is passed on to the utility's customers, with the same effect. Assuming no other factors become involved, the total loss of taxes may be computed as the initial loss divided by the excess of 100 over the utility's marginal tax rate. At the present surcharge rates, the total tax loss is 212 percent of the initial loss; without the surcharge, the total loss is 192 percent of the initial loss.

Your committee has been advised that, if those trends were to continue, there could very shortly be a revenue loss of approximately $1.5 billion; some estimates indicate that the loss might be considerably closer to $2 billion per year. Your committee has determined that the likely revenue loss from wholesale shifts to accelerated depreciation and flow through is unacceptable at this time.

Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their

attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.

[133] Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more healthy utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return.

Explanation of provisions.—Your committee's bill provides that, in the case of existing property, the following rules are to apply:

(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

(3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.

The taxpayer's present method of depreciation is to be determined by reference to its latest tax return filed before July 22, 1969 (the date your committee's tentative decisions on this subject were published). Property placed in service after the taxable year to which that return relates and before January 1, 1970, will be treated in the same manner as the same kind of property is treated on that return. The taxpayer's present method of treating tax deferrals will be determined by reference to its regulated books of account as of July 22, 1969.

In the case of new property (property completed or acquired after December 31, 1969) the bill provides that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it must stay on accelerated depreciation and flow through unless the regulatory agency permits it to change. In all other cases, accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. (The taxpayer will be permitted to elect straight line depreciation as to such new property and, if the taxpayer seeks to use accelerated depreciation, the regulatory agency will be permitted to in effect force the taxpayer to straight line depreciation by not permitting normalization. The regulatory agency will not, in such cases, be permitted to require flow through of deferred taxes.)

The rules provided by the bill are to apply to property used predominantly in the trade or business of the furnishing or sale of: electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by COMSAT), or transportation of gas, oil (including shale oil), or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency.

Where normalization is used, this bill in no way diminishes whatever power the agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated.

It is expected that regulations will provide for proper allocation of property where more than one agency supervises the activities of a utility, if the several agencies apply different rules to the utility's property.

Effective date.—These amendments apply with respect to taxable years ending after July 22, 1969.

[134] *Revenue effect.*—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979.

APPENDIX B

Pertinent Provisions of Report of Senate Committee on Finance on Tax Reform Act of 1969, Senate Report No. 91-552, 91st Cong., 1st Session

[171] N. DEPRECIATION ALLOWED REGULATED INDUSTRIES

(Sec. 441 of the bill and sec. 167(l) of the code)

Present law.—Regulated industries may make the same elections as other taxpayers regarding depreciation of their business property. About half the regulatory agencies require utilities that use accelerated depreciation to "flow through" the resulting reduction in Federal in- [172] come taxes currently to income. (Where the utility is earning the maximum allowed by law or regulations, this results in flowing through the tax reduction to the utility's current customers.) Other agencies permit the utilities they regulate to "normalize" the deferred tax liabilities resulting from accelerated depreciation. (This involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.) Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, such agencies have treated the utilities they regulate as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight-line depreciation.

General reasons for change.—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Such a revenue loss from this item is unacceptable at this time.

On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

Accordingly, the committee agrees with the House that it is appropriate to in general "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return.

Explanation of provisions.—Both the House bill and the committee amendments provide that if a company (a) is in one of the regulated industries to which the bill applies and (b) at present takes accelerated depreciation and normalizes, or takes straight line depreciation, then the company is not to be permitted to take accelerated depreciation on its tax return unless it normalizes on its regulated books of account for rate-making purposes. Other companies—those that now flow through, as well as those in other regulated industries—are not limited by this general rule of the bill.

Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:

(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

(2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must shift to the straight line method unless it continues to normalize as to that property.

[173] (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below), unless the appropriate regulatory agency permits a change as to that property.

Both versions of the bill in the case of new property have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below applies). In all other cases, accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. The taxpayer is permitted to elect straight line depreciation as to this new property. If the taxpayer seeks to use accelerated depreciation, the regulatory agency may permit it to normalize; if the regulatory agency does not, the taxpayer must use straight line depreciation.

The bill does not change the power of the regulatory agencies in the case of normalization to exclude the normalized tax reduction from the base upon which the agency computes the company's maximum permitted profits.

Both the House bill and the committee amendments provide that the rules set forth above are to apply to property used predominantly in the trade or business of the furnishing or sale of—

(1) Electrical energy;

(2) Water;

(3) Sewage disposal services;

(4) Gas through a local distribution system;

(5) Telephone services; or

(6) Transportation of gas by pipeline.

In all of the above cases the rules of the bill apply if the rates for such furnishing or sale are regulated by a utilities commission or similar agency.

The committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill).

This election applies both as to new and existing property. In order to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, the bill provides that the election will take effect at the start of the company's first taxable year beginning after December 31, 1970. If the books and rates have been conformed to normalization by then, the company may continue to use accelerated depreciation so long as it continues to normalize; if not, the company must use only straight line depreciation. Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency would not be able to impute the use of ac- [174] celerated depreciation with flow-through. In other words, a company that

makes this election would be under the general rule of the bill after its election takes effect.

A number of other changes are also made by the committee amendments.

Oil pipelines are removed from the category of companies covered by the bill and regulated steam producers are included in the categories covered. In addition, Comsat, which was specifically excluded under the House bill, is included in industries covered by the provision.

In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The committee amendments permit such a definition of normalization and do not require that additions be to a separate account described as a "reserve for deferred taxes."

The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.

The committee amendments provide that a taxpayer is not to be treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation deducted on the return is normalized. However, this rule is to be applied for the future only.

Under this rule, differences in the amount of depreciation expense need not be normalized if they result from such differences as (a) use of so-called "guideline lives" for tax purposes and "engineering lives" on the regulated books and (b) different bases for the property because the agency requires that certain carrying charges be capitalized even though for tax purposes they may be deducted or because the agency requires a carryover basis in the case of a purchase of property from another regulated utility even though for tax purposes the basis is what the purchasing company paid for the property.

However, any difference resulting from a faster method of depreciation (including the use of a faster declining balance rate) must be normalized. For example, if a company takes straight line depreciation on its regulated books of account and 200 percent declining balance on its tax return, it does not meet the test of the bill if it normalizes only with respect to the difference between 200 percent declining balance and 150 percent declining balance.

Under the committee amendments, the status of a company as to whether it is on straight line, normalizing, or flow through is to be determined as of August 1, 1969 (instead of July 22, 1969, under the House bill).

Accordingly, the determination of the present method of depreciation generally is to be made by reference to the return for the last taxable year for which a return was filed before August 1, 1969. (It is expected that in most cases this will be the return for calendar [175] 1968). Property not reflected on that last return as public utility property, which is used as public utility property before January 1, 1970, is to be treated the same as property of the same kind or, if there is no property of the same kind, property of the most nearly similar kind that is reflected on that return. If the company's last tax return reflected two methods of depreciation for a kind of property—for example, where it

used straight line depreciation for property put in service through 1964 but used 200 percent declining balance for property put in service since then—the method to be used for property not reflected on the return would be 200 percent declining balance, the method used for the newer property.

Under another provision of the bill (sec. 521, described below), real estate depreciation allowances have been revised, and the most accelerated methods of depreciation (the 200-percent declining balance and sum of the years-digits methods) are no longer permitted with respect to new real estate (other than residential housing); later-acquired used real estate is limited to straight line depreciation. The committee amendments provide that in the case of real estate to which the new limitations on allowable depreciation for regulated utilities apply, that method permitted by the new limitations which is most nearly comparable to the method of depreciation used on the taxpayer's pre-August 1, 1969, return is to be considered to be the taxpayer's present method of depreciation. For example, if the taxpayer used 200 percent declining balance for its new property on its latest tax return filed before August 1, 1969, and in the future acquires new public utility property of the same kind, the 150-percent declining balance method would be its most nearly comparable method.

Under the committee amendments, the status of a company is not necessarily to be determined only by the method of depreciation used on its tax return. Utilities that have used accelerated depreciation (with flow through) in computing their tax expense on their regulated books of account for the latest monthly period ending on or before August 1, 1969, are to be permitted to elect accelerated depreciation (with flow through) for such property and for future acquisitions. In addition, the committee amendments provide that a utility which has filed a request with the Internal Revenue Service for permission to change from

straight line to accelerated depreciation is to be permitted to make that change for such property and for future acquisitions.

Also, if a company adopts flow-through in compliance with a change authorized within 90 days after the date of enactment of the bill by the appropriate State agency pursuant to proceedings instituted by that agency before April 22, 1969 (the date the Treasury Department first made public its recommendations on this subject), during which the company proposed before April 22, 1969, to reduce its rates immediately after being authorized by the State agency to adopt flow-through, then it will be treated as a flow-through company. These provisions are intended to permit companies that have effectively committed themselves to a particular status in their official dealings with the appropriate government agencies to be treated as having attained that committed status.

When the term "straight line depreciation" is used in the above description (and also with regard to the earnings and profits and the real estate depreciation provisions described below) it is intended to encompass also other ratable methods such as units of production and machine hours (but not the so-called "forecast of income" method).

The provision also authorizes the use of regulations to provide for proper application of this provision where more than one agency supervises the activities of a company if the several agencies apply different rules to the company's property, where companies are involved in reorganizations, mergers, or other acquisitions, and in other circumstances in order to carry out the purposes of this provision.

Effective date.—Under the committee amendments, the new rules are to apply to all taxable years for which a return has not been filed before August 1, 1969, even though those years may have ended before that date.

Revenue effect.—The revenue increases under these amendments are estimated at $60 million in 1970, $260 million in 1974, and $310 million in 1979. This does not take into account any possible elections of those on flow through to shift, within a 180-day period, to straight line or normalization (if permitted by their regulatory agency) with respect to both future and existing property, since it is not possible to know how many will make such an election.

APPENDIX C

Pertinent Provisions of Report of Conference Committee on Tax Reform Act of 1969, House Report No. 91-782, 91st Cong., 1st Session

[312] SUBTITLE E—DEPRECIATION ALLOWED REGULATED INDUSTRIES; EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION

1. Depreciation allowed regulated industries (sec. 167 of the code)

The House bill provides that in the case of certain listed regulated industries (the furnishing or sale of electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services, and transportation of gas by pipeline) a taxpayer is not permitted to use accelerated depreciation unless it "normalizes" the current income tax reduction resulting from the use of such accelerated depreciation. (Normalization involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.)

This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account. Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.

The Senate amendment makes the following changes in the House bill: (*a*) oil pipelines are removed from and steam transporters and distributors and Comsat are added to the categories of utilities to which the provision applies; (*b*) where a company was in the process of changing methods of depreciation or methods of keeping its regulated books of account, the company is treated as having

changed if it had filed a timely request for permission to change before August 1, 1969, or had changed in its regulated books of account for its July 1969 accounting period; (*c*) several technical changes are made to insure that the normalization requirement is not avoided by those to whom the bill applies; (*d*) an election is [313] permitted to be made within 180 days after the date of enactment by a company at present on flowthrough to come under the rules of the bill; and (*e*) a special provision permits a company under specified circumstances to avoid the rules of the bill by changing from normalization to flowthrough.

The conference substitute (sec. 441 of the substitute and sec. 167(l) of the code) follows the Senate amendment except that the special provision referred to in (*e*) above is stricken and the 180-day election (item (*d*), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company.

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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, PETITIONER

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, PETITIONER

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION

OPINIONS BELOW

The initial opinion of the court of appeals (Pet. App. 17-39)[1] and its opinion on rehearing (Pet. App. 41-53) are reported at 462 F. 2d 853, 865. The initial opinion (No. 578) of the Federal Power Commission (Pet. App. 57-66) and its opinion on rehearing (No.

[1] "Pet. App." references are to the appendices to the petition in No. 72-486.

578–A; Pet. App. 67–71) are reported at 43 FPC 824 and 44 FPC 140.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972 (Pet. App. 55–56), and the Commission's petition for rehearing was denied on May 11, 1972 (Pet. App. 41–53). On August 4, 1972, the Chief Justice extended the time for filing petitions for writs of certiorari to September 23, 1972. The petitions were filed on September 22, 1972. On December 6, 1972, the Court granted both petitions and consolidated the cases. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether Section 441(a) of the Tax Reform Act of 1969 was intended to withdraw from the Federal Power Commission and other agencies charged with similar regulatory responsibilities the authority to permit a utility, in calculating its federal income tax allowance for ratemaking purposes, to conform its method of computing depreciation on its other property to the method it had elected under the Act to be applicable to its expansion property acquired after 1969.

2. Whether, assuming Section 441(a) did not affect the Federal Power Commission's authority to permit a utility to conform its depreciation methods, the Commission's action in this case was proper.

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 626, 26 U.S.C. 167(*l*), is set forth in an appendix to this brief, *infra*, pp. 35–40.

STATEMENT

A. BACKGROUND

It has long been established that federal income taxes are properly includable as an expense under the cost of service method of ratemaking utilized by the Federal Power Commission in the regulation of rates for sales of natural gas subject to its jurisdiction under the Natural Gas Act, 15 U.S.C. 717 *et seq.* The method of calculating such taxes for ratemaking purposes, however, may not be the same as the method used for calculating the taxes actually paid.

With the adoption of Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, companies, including regulated utilities, were authorized for the first time to use liberalized or accelerated depreciation in calculating their federal income taxes. Under any of the several methods of liberalized depreciation authorized by Section 167(b), a company may take relatively large depreciation deductions in calculating its federal income taxes during the initial years of an asset's useful life and compensatingly lesser amounts during the later years of the asset's useful life; the aggregate amount of depreciation allowed for tax purposes over the entire life of the asset is the same under the liberalized depreciation method as under the straight-line method where the annual depreciation

deductions are constant throughout an asset's useful life. As the legislative history of Section 167 discloses, Congress anticipated the liberalized depreciation provisions would increase working capital and encourage the "modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 26; H. Rep. No. 1337, 83d Cong, 2d Sess., p. 24.

While Section 167 specified that liberalized depreciation could be used in calculating a company's actual federal income taxes, the question of what depreciation method companies subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, and the Federal Power Act, 16 U.S.C. 791a *et seq.*, should use for the purpose of calculating their federal income tax expense for ratemaking purposes was left within the Commission's discretion.[2] The Commission at first determined that the use of liberalized depreciation for tax purposes merely resulted in a tax deferral and, to avoid benefiting the present customers of a utility at the expense of later customers who would have to pay the deferred taxes, the Commission decided that the income tax expense allowed as a cost of service for ratemaking purposes

[2] The present case is concerned solely with the depreciation methods used by utilities in calculating either their actual federal income taxes or their federal income tax expenses for ratemaking purposes. Not involved is the accounting method prescribed by the Commission for use in calculating depreciation as a separate, non-tax expense to be reflected in establishing rates.

should be "normalized," *i.e.*, computed as if the company were using straight-line depreciation. The difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferred tax reserve account for the payment of future taxes. See *Amere Gas Utilities Co.*, 15 FPC 760, 781; *Cities of Lexington, etc., Ky.* v. *Federal Power Commission*, 295 F. 2d 109, 114 (C.A. 4).

In *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, affirmed *sub nom. Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F. 2d 318 (C.A. 5), certiorari denied, 385 U.S. 847, the Commission reconsidered the issue and found that the use of liberalized depreciation by utilities usually resulted in permanent tax savings since most utilities had growing or stable plant investments.[3] Accordingly, the Commission ordered utilities using liberalized depreciation for tax purposes to use the same method for calculating their tax expenses for ratemaking purposes, and thus to "flow-through" to their customers the resultant tax savings.[4] Finally, in *Midwestern Gas Transmission Co.*, 36 FPC 61, affirmed *sub nom. Midwestern Gas Transmission Co.* v. *Federal*

[3] A growing company using liberalized depreciation generally has enough new and replacement property to generate sufficient depreciation allowances to offset the declining depreciation allowances on its existing property.

[4] In the same case, the Commission initiated the policy now in effect that the deferred tax reserve accumulated by a utility that had been using normalization must be deducted from the utility's rate base so that no return on the tax savings would be included in its rates. 31 FPC at 220–221.

Power Commission, 388 F. 2d 444 (C.A. 7), certiorari denied, 392 U.S. 928, the Commission held that for ratemaking purposes it would impute the use of liberalized tax depreciation to any company which shifted from liberalized tax depreciation to straight-line depreciation for calculating its actual taxes and thus would flow through the resulting imputed tax savings to the company's customers. Thus, if the company persisted in using straight-line depreciation for tax purposes, its actual taxes would be higher than the taxes it would be permitted to claim as an expense for ratemaking purposes.

B. SECTION 441(a) OF THE TAX REFORM ACT OF 1969

In considering tax reform legislation in 1969, the House Ways and Means Committee expressed concern about the loss of tax revenues resulting from the shifting by regulated utilities either from straight-line depreciation to liberalized depreciation or from liberalized depreciation with normalization to liberalized depreciation with flow-through;* the committee also cited with disapproval the practice of several regulatory agencies of imputing for ratemaking purposes the use of liberalized depreciation with flow-through to utilities using straight-line depreciation for tax purposes. H. Rep. No. 91-413 (Part 1), 91st Cong.,

* Shifts from straight-line depreciation to liberalized depreciation for tax purposes result in tax revenue losses since depreciation deductions are higher; shifts from liberalized depreciation with normalization to liberalized depreciation with flow-through result in tax revenue losses since the tax benefits are flowed-through to customers by means of lower rates than would otherwise prevail, thus reducing utilities' gross revenues.

1st Sess., pp. 131–132. On the other hand, the House committee rejected suggestions by the Commission and others that all utilities using liberalized depreciation be required to change to straight-line depreciation, since such a rule would place some utilities at a competitive disadvantage and would result in substantial rate increases (*id.* at 132). Accordingly, the committee proposed and the House passed a "freeze" on existing depreciation practices on existing property subject to the following three general rules (*id.* at 133):

> (1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.
>
> (2) If the taxpayer is taking accelerated depreciation and is "normalizing" its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property.

The Senate Committee on Finance, while also expressing concern about the loss of tax revenues from utility depreciation practices, similarly rejected a requirement that all utilities use straight-line depreciation. S. Rep. No. 91–552, 91st Cong., 1st Sess., pp. 172–173. The committee proposed and the Senate passed legislation similar to the House bill, except that utilities on flow-through were given the right to elect within 180 days of the enactment of the bill

> * * * to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or * * * with the permission of the regulatory agency to shift to the normalization method (that is, to come under general rules of the bill). [*Id.* at 173.]

In conference, the Senate bill was amended to limit a utility's right of election to property acquired by the utility after 1969 to expand its facilities. See H. Conf. Rep. No. 91–782, 91st Cong., 1st Sess., pp. 312–313. As thus amended, the depreciation provisions were enacted as Section 441(a) of the Tax Reform Act of 1969.

Section 441(a) added a new subsection (*l*) to Section 167 of the Internal Revenue Code of 1954, 26 U.S.C. 167(*l*), prescribing what constitutes a "reasonable allowance" for depreciation of public utility property for computing the depreciation deduction under Section 167(a). Section 167(*l*)(3)(B) and (C) distinguishes between pre-1970 property, or property acquired before January 1, 1970, and post-1969 property, or property acquired on or after January 1, 1970. Section 167(*l*)(4)(A) establishes an additional category of post-1969 property which "increases the productive or operational capacity of the taxpayer * * * and does not represent the replacement of existing capacity" (referred to hereafter as "expansion property").

Under Section 167(*l*)(1), a "reasonable allowance" for depreciation for pre-1970 property is an allowance computed under either (1) a "subsection (*l*)" (essen-

tially straight-line, see Section 167(*l*) (3)(F)) method, (2) the method used on tax returns prior to August 1, 1969, on the property or similar property if the company uses normalization, or (3) accelerated depreciation with flow-through if the company used flow-through prior to August 1, 1969. Under Section 167(*l*)(2), a "reasonable allowance" for depreciation for post-1969 property is an allowance computed under either (1) a "subsection (*l*)" method, (2) accelerated depreciation with normalization, or (3) accelerated depreciation with flow-through if the company used flow-through prior to August 1, 1969. Under the election provision, Section 167(*l*)(4)(A), a utility may elect not to have the third option (accelerated depreciation with flow-through) apply to its post-1969 expansion property.

C. PROCEEDINGS BEFORE THE COMMISSION

Following enactment of the Tax Reform Act of 1969, the Texas Gas Transmission Corporation, in the context of pending rate proceedings, advised the Commission of its intent to elect under Section 167(*l*)(4)(A) of the Code to abandon flow-through with respect to its expansion property and, with the Commission's permission, to use liberalized depreciation with normalization with respect to such property in computing its federal income taxes (Pet. App. 59). Before it made the election, however, Texas Gas sought permission to change from flow-through to straight-line depreciation, or, preferably, liberalized depreciation with normalization with respect to its pre–1970 property and

post–1969 replacement property (collectively "existing and replacement property") (*ibid.*).

In Order No. 404, 43 FPC 740, rehearing denied, 44 FPC 16, the Commission announced that as a general policy it would permit utilities making the election under Section 167(*l*)(4)(A) to use liberalized depreciation with normalization with respect to their expansion property.

Subsequently, the Commission issued Opinion No. 578 in Texas Gas' pending rate proceedings permitting Texas Gas to shift to liberalized depreciation with normalization with respect to all its property (Pet. App. 57–66). The Commission found that once Texas Gas had elected to abandon flow-through with respect to its expansion property, the continued use of flow-through with respect to its existing and replacement property would result in a steadily increasing tax expense for ratemaking purposes, since liberalized depreciation on new facilities would no longer be available to offset declining depreciation on existing facilities (Pet. App. 62–63). The Commission concluded that the use of normalization with respect to Texas Gas' existing and replacement property was necessary to promote stable rates (Pet. App. 63).

In accordance with its established practice (see p. 5, *supra*), the Commission required Texas Gas to put the difference between the taxes actually paid and the taxes that would have been paid under straight-line depreciation (and are claimed as a cost of service for ratemaking purposes) into a deferred tax reserve. The

reserve was required to be deducted from the rate base so that the company would not earn any return on the reserve (Pet. App. 65).[6]

D. THE DECISION BELOW

Petitions for review were filed with respect to both Order No. 404 and Opinion No. 578 and were consolidated by the court of appeals. The court upheld the Commission's decision in Order No. 404 to permit utilities electing to abandon flow-through with respect to their expansion property to use liberalized depreciation with normalization on such property (Pet. App. 20–29).[7]

The court below reversed the Commission, however, with respect to Opinion No. 578; it held that Section 441(a) of the Tax Reform Act deprived the Commission of authority to permit utilities to abandon flow-through with respect to their existing and replacement property (Pet. App. 29–39). The court recognized that the original version of the legislation adopted by the House did not limit this authority, but construed the election provision proposed by the

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[6] Texas Gas' customers would thus benefit indirectly from the use of liberalized depreciation with normalization, since the reserve provides the company with capital for the expansion of facilities or the improvement of service at no cost to its customers.

[7] A petition for a writ of certiorari to review this aspect of the decision below was denied by this Court on October 16, 1972. *Memphis Light, Gas and Water Division* v. *Federal Power Commission, et al.*, No. 72–96.

Senate and narrowed in conference as a limitation on the House bill (Pet. App. 31–34). In denying petitions for rehearing, the court reaffirmed its interpretation of Section 441(a) and its legislative history (Pet. App. 41–53).

SUMMARY OF ARGUMENT

1. The Federal Power Commission has traditionally exercised broad authority under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, subject only to limited judicial review, over the rates charged by natural gas companies for the transportation or sale for resale of natural gas in interstate commerce. This authority over rates includes the power to determine the proper allowance to be made for federal income taxes as a cost of service.

Prior to the enactment of the Tax Reform Act of 1969, it was settled that the Commission could, in its discretion, determine the method that companies using liberalized depreciation in calculating their actual federal income taxes should use to compute depreciation in calculating their taxes as a cost of service for ratemaking purposes. With the adoption of Section 441(a) of the Tax Reform Act, Congress restricted the Commission's authority in certain respects—most notably, by giving utilities the unrestricted right to abandon flow-through accounting with respect to their post-1969 expansion property. But in most other respects, the Commission's authority

over tax depreciation practices was left unimpaired. Neither the language nor the legislative history of Section 441(a) supports the holding below that the Commission now lacks the power to permit a utility to change from accelerated depreciation with flow-through to accelerated depreciation with normalization with respect to its existing and replacement property.

Section 441(a) added a new subsection (*l*) to Section 167 of the Internal Revenue Code of 1954. Section 167(*l*)(1) and (2) lists the alternate methods utilities may use in determining depreciation for tax purposes. One of the methods is accelerated depreciation with flow-through if a company used flow-through prior to August 1, 1969. Nothing in the statute, however, implies that a company on flow-through must stay on flow-through and that the Commission or other appropriate regulatory agency lacks the power to permit the company to abandon flow-through.

The legislative history of Section 441(a) confirms the conclusion that Congress did not intend to deprive the Commission of the authority to permit abandonments of flow-through with respect to existing and replacement property. The House report on the initial House version of the legislation expressly referred to such authority. H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess., p. 133. The Senate amended the House bill to give utilities the right to elect within 180 days of the enactment of the statute to abandon flow-

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through on all their property. The Senate report makes clear, however, that this right of election merely provided an additional method whereby utilities could get off flow-through; the continued authority of the Commission to permit abandonments of flow-through was expressly acknowledged. S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 172-173. Accordingly, this authority was not disturbed when the conference amended the bill by limiting the right of election contained in the Senate amendment to post-1969 expansion property.

Finally, the language in the House and Senate reports stating that the legislation was intended to "freeze" existing depreciation practices (H. Rep. No. 91-413, *supra*, pp. 132-133; S. Rep. No. 91-552, *supra*, p. 172) does not support the decision below. The "freeze" was qualified by the general rules embodied in the legislation and summarized in both reports.

2. If the Court agrees with us that the Commission has the authority to permit abandonments of flow-through with respect to existing and replacement property, the Court should affirm the Commission's order permitting Texas Gas to use accelerated depreciation with normalization on its existing and replacement property. Although the court of appeals did not reach the question whether the Commission acted within its discretion in this case, there are no substantial issues requiring further consideration by that court.

ARGUMENT

I

SECTION 167(*l*) OF THE INTERNAL REVENUE CODE DOES NOT DEPRIVE THE FEDERAL POWER COMMISSION OF THE AUTHORITY TO PERMIT UTILITIES SUBJECT TO ITS JURISDICTION TO CHANGE FROM ACCELERATED DEPRECIATION WITH FLOW-THROUGH TO ACCELERATED DEPRECIATION WITH NORMALIZATION WITH RESPECT TO THEIR EXISTING AND REPLACEMENT PROPERTY

A. THE COMMISSION'S BROAD AUTHORITY OVER RATES UNDER THE NATURAL GAS ACT, 15 U.S.C. 717 *ET SEQ.*, INCLUDES AS A GENERAL MATTER THE AUTHORITY TO DETERMINE THE PROPER ALLOWANCE FOR FEDERAL INCOME TAXES AS A COST OF SERVICE

Under the Natural Gas Act, 15 U.S.C. 717 *et seq.*, all rates and charges imposed by natural gas companies[*] for the transportation or sale for resale of natural gas in interstate commerce must be just and reasonable and the Federal Power Commission has the authority to investigate such rates and charges, set aside those which are not just and reasonable and prescribe rates and charges which meet the statutory standard. 15 U.S.C. 717c, 717d. Rates charged by electric utilities subject to the Federal Power Act, 16 U.S.C. 791a *et seq.*, for the transmission or sale for resale of electric energy in interstate commerce must also be just and reasonable and are similarly subject to Commission scrutiny. 16 U.S.C. 824d, 824e.

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[*] A "natural gas company" is a company engaged in the transportation or sale for resale of natural gas in interstate commerce. 15 U.S.C. 717a(6).

In fixing just and reasonable rates under the Natural Gas Act, the Commission is not bound to use "any single formula or combination of formulas," but is "free . . . to make the pragmatic adjustments which may be called for by particular circumstances." *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586. Moreover, rate orders and the underlying methods used by the Commission in promulgating rate orders are subject to only limited judicial review. As this Court noted in *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602: "If the total effect of [a] rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [Natural Gas] Act is at an end. . . . [A rate order] is the product of expert judgment which carries a presumption of validity." And in the *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, the Court referred to the "broad responsibilities" given the Commission by Congress and held that the Commission "must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests." Finally, the Court has specifically held that the Commission's jurisdiction over rates includes the authority to determine what proper allowance should be made for federal income taxes as a cost of service. *Federal Power Commission* v. *United Gas Pipe Line Co.*, 386 U.S. 237, 243.

Prior to the enactment of the Tax Reform Act of 1969, the Federal Power Commission, in meeting its

ratemaking responsibilities under the Natural Gas Act and the Federal Power Act, exercised broad authority over the methods that electric utilities and natural gas companies subject to its jurisdiction used to compute depreciation in calculating federal income taxes as a cost of service for ratemaking purposes (see pp. 4–6, *supra*) and this broad authority was recognized by the courts. In upholding the Commission's initial decision to require companies using liberalized depreciation for tax purposes to normalize their taxes for ratemaking purposes, the Court of Appeals for the Fourth Circuit stated:

> It is obvious that we are confronted in this case with a problem in a special field which requires the exercise of expert skill that has been generally entrusted by state and Federal legislation to administrative regulatory tribunals whose decisions, in the absence of abuse of discretion, should be followed by the courts. We adopt that course in this case. [*Cities of Lexington, etc., Ky.* v. *Federal Power Commission*, 295 F. 2d 109, 114.]

When the Commission subsequently determined that the tax benefits from liberalized depreciation should be flowed through to consumers, that determination was also found to be a proper exercise of the Commission's broad regulatory powers over rates. *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F. 2d 318, 328–330 (C.A. 5), certiorari denied, 385 U.S. 847. In *Alabama-Tennessee*, the court of appeals carefully reviewed the legislative history of the accelerated depreciation provisions con-

tained in Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51, and concluded (359 F. 2d at 335, footnote omitted):

> * * * It is unlikely to suppose that Congress amended the Natural Gas Act by a reference in the Internal Revenue Code; it is unreasonable to read Section 167 as a mandate reducing the Commission's responsibility to fix fair rates according to its usual ratemaking policies in favor of the consumer. At bottom, the question before us was and is one for Congress to decide. Assuming that Congress considered the effect of Section 167 on ratemaking at the time of enactment or later, we infer that its decision not to disturb, in terms, the status quo of ratemaking indicates a congressional intent that each federal regulatory agency should continue to exercise an informed discretionary authority in accordance with the agency's usual standards in the light of the needs peculiar to the particular industry subject to rate regulation.

See also *City of Chicago* v. *Federal Power Commission*, 385 F. 2d 629 (C.A.D.C.), certiorari denied *sub nom. Public Service Commission of Wisconsin* v. *Federal Power Commission*, 390 U.S. 945; *Midwestern Gas Transmission Co.* v. *Federal Power Commission*, 388 F. 2d 444 (C.A. 7), certiorari denied, 392 U.S. 928.

It is in the light of this background of broad regulatory authority over rates, including the authority to determine how federal income taxes should be reflected for ratemaking purposes, that we turn to Section 441(a) of the Tax Reform Act of 1969.

2. NOTHING IN THE LANGUAGE OF SECTION 167(*l*) RESTRICTS THE AUTHORITY OF THE COMMISSION TO PERMIT CHANGES FROM ACCELERATED DEPRECIATION WITH FLOW-THROUGH TO ACCELERATED DEPRECIATION WITH NORMALIZATION WITH RESPECT TO EXISTING AND REPLACEMENT PROPERTY

There is no doubt that Congress, in enacting Section 441(a) of the Tax Reform Act of 1969, deliberately restricted to some extent the authority of regulatory agencies to prescribe the depreciation methods to be used by utilities in reflecting their federal income taxes on their books of account for ratemaking purposes. For example, a utility which used accelerated depreciation with normalization with respect to its pre–1970 property prior to the enactment of the Tax Reform Act cannot now be required by a regulatory agency to switch to flow-through since under Section 167(*l*)(1) of the Code the use of accelerated depreciation with flow-through by the utility on such property would not result in a "reasonable allowance" for depreciation under Section 167(a). Similarly, the election provision in Section 167(*l*)(4)(A) prohibits the Commission from imputing the use of liberalized depreciation with flow-through for expansion property to utilities electing to abandon flow-through with respect to such property.[9] But the carefully specified,

[9] Section 167 (*l*)(4)(A) provides that if a taxpayer makes an election within 180 days following the enactment of the statute, paragraph (2)(C)—permitting the use of accelerated depreciation with flow-through on post-1969 property if that method was used on similar property prior to August 1, 1969—"shall not apply." The utility's right to make the election within the prescribed period is unqualified and thus not conditioned upon regulatory approval. For a discussion of the legislative history of this provision, see our brief in opposition in No. 72–96 (n. 7, *supra*).

explicit restriction of regulatory discretion in these narrow circumstances by no means implies a wholesale elimination of traditional regulatory authority over depreciation methods used for determining tax expense as a cost of service in ratemaking.

As noted above (pp. 8-9, *supra*), Section 167(*l*)(1) and (2) sets forth the depreciation methods which will result in a "reasonable allowance" for depreciation for federal income tax purposes. One of those methods is accelerated depreciation with flow-through if a company used flow-through prior to August 1, 1969. Section 167(*l*)(1)(B) and (2)(C). Nothing in the statute, however, suggests that a company *must* use that method and that the appropriate regulatory authority may not permit it to use one of the other methods also set forth in the statute—*i.e.*, straight-line depreciation or accelerated depreciation with normalization. Section 167(*l*)(1)(A), (2)(A), and (2)(B). In fact, Section 167(*l*)(1)(B) provides:

> FLOW-THROUGH METHOD OF ACCOUNTING IN CERTAIN CASES.—In the case of any pre-1970 public utility property, the taxpayer *may* [emphasis supplied] use the applicable 1968 method for such property if—
>
> . . .
>
> the taxpayer used flow-through on the property or similar property prior to August 1, 1969.

The use of the word "may" strongly suggests that Congress contemplated that utilities which had been using liberalized depreciation with flow-through might seek per-

mission from the appropriate regulatory authority to abandon flow-through.[19]

In short, the statute merely lists alternate permissible methods of calculating depreciation, but does not specify which alternative a utility must use, if the utility is covered by more than one alternative. Under these circumstances, there is no basis in the language of the statute for concluding that, except where the statute is explicit as in the election provision, Congress intended to deprive the Federal Power Commission and other regulatory agencies of their traditional authority over depreciation methods used to determine federal income taxes as a cost of service for rate-making purposes.

C. THE LEGISLATIVE HISTORY OF SECTION 167(*l*) CONFIRMS THAT CONGRESS DID NOT INTEND TO DEPRIVE THE COMMISSION OF THE AUTHORITY TO PERMIT UTILITIES TO ABANDON FLOW-THROUGH WITH RESPECT TO EXISTING AND REPLACEMENT PROPERTY

Although Section 167(*l*) does not specifically refer to the authority of regulatory agencies over depreciation methods used in calculating income taxes, we have shown that the statute on its face does not restrict

[19] Section 167(*l*)(2)(C)—permitting the use of liberalized depreciation with flow-through on post-1969 property if used on similar property prior to August 1, 1969—does not contain the word "may" since the Section is structured differently from Section 167(*l*)(1)(B). There is no reason to believe, however, that a regulatory agency's authority to permit abandonment of flow-through is any different with respect to post-1969 replacement property (post-1969 expansion property, of course, is subject to the election provision of Section 167(*l*)(4)(A)) than it is with respect to pre-1970 property.

agency authority to permit a utility to change from accelerated depreciation with flow-through to accelerated depreciation with normalization with respect to existing and replacement property. We turn now to the legislative history of Section 167(*l*)—Section 441(a) of the Tax Reform Act of 1969—which discloses that Congress specifically acknowledged and did not disturb the authority of regulatory agencies to permit such a change.

1. As we have noted (see p. 7, *supra*), the initial House version of what became Section 441(a) embodied three general rules with respect to depreciation practices on existing property, the third of which required a utility using liberalized depreciation with flow-through on its existing property to continue using that method of depreciation, "unless the appropriate regulatory agency permits a change as to that property." H. Rep. No. 91-413, *supra*, p. 133. Similarly, if the utility was using liberalized depreciation with flow-through on its existing property, it was required under the House bill to use flow-through on its new property "unless the regulatory agency permits it to change" (*ibid.*). Contrary to the conclusions of the court below (Pet. App. 30-36, 42-45), neither the Senate nor the Conference amendments to the House bill altered the authority of regulatory agencies, expressly acknowledged by the House Ways and Means Committee, to permit the abandonment of flow-through.

The Senate report explains that the Senate amendments follow the general rules of the House bill, ex-

cept that the Senate version of the legislation also gave each utility the right to elect to abandon flow-through and use either straight-line depreciation or, if permitted by the appropriate regulatory agency, accelerated depreciation with normalization. S. Rep. No. 91-552, *supra*, p. 173. With respect to the general rules adopted from the House bill, the Senate report states (*id.* at 172-173):

> Both the House bill and the committee amendments provide that in the case of existing property the following rules are to apply:
>
> * * * * *
>
> (3) If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so (except as provided under the committee amendments which are discussed below [*i.e.*, the election provision]), unless the appropriate regulatory agency permits a change as to that property.

The Senate report also notes that with respect to new property, both the House and Senate versions of the bill (*id.* at 173)

> * * * have the effect that if the taxpayer presently flows through to its customers the benefits of deferred taxation, then it would stay on accelerated depreciation and flow through unless the regulatory agency permits it to change (or unless the exception under the committee amendments pointed out below [again, the election provision] applies).

As both the above passages make clear, the Senate bill required utilities to stay on flow-through unless either (1) the appropriate regulatory agency permitted a change under the general rules of the bill, or (2) the utility exercised its right of election. In other words, the right of election adopted by the Senate to be applicable to all utility property simply provided an additional procedure whereby utilities may get off flow-through, but did not restrict the authority of regulatory agencies generally to permit the abandonment of flow-through.

The Conference restricted the right of election added by the Senate to post-1969 expansion property, but otherwise followed the Senate amendments (H. Conf. Rep. No. 91–782, *supra*, pp. 312–313); it thus did not disturb the regulatory authority recognized by the general rules referred to in the House and Senate reports. In reaching the contrary conclusion, the court below (Pet. App. 33–34) placed great emphasis on the Conference report. The report's discussion of the depreciation provisions is contained in four paragraphs, the pertinent provisions of which are as follows (H. Conf. Rep. 91–782, *supra*, pp. 312–313):

> The House bill provides that in the case of certain listed regulated industries * * * a taxpayer is not permitted to use accelerated depreciation unless it "normalizes" * * *.
>
> This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account. * * *

> The Senate amendment makes the following changes in the House bill: * * * (d) an election is permitted to be made within 180 days after the date of enactment by a company at present on flow-through to come under the rules of the bill; * * *.
>
> The conference substitute (sec. 441 of the substitute and sec. 167(*l*) of the code) follows the Senate amendment except that * * * the 180-day election (item (d), above) is modified to apply to [post-1969 expansion property] * * *.

The court below construed "This rule" in the second paragraph of the report to refer to the final version of the statute as approved by the conference and thus concluded that there was no way a utility could get off flow-through with respect to existing property. A close reading of the report, however, discloses that "This rule" does not refer to the final bill, but refers to the initial House bill summarized in the first two paragraphs of the report's discussion of the depreciation provisions; the third paragraph discusses the Senate amendments and only the fourth paragraph explains the conference modifications of the legislation. When the first two paragraphs are read together, the second paragraph merely states that a company on flow-through *may* remain on flow-through; it does *not* state—what the court below itself conceded the House bill did not provide—that a company on flow-through could not abandon flow-through with respect to its existing property with the permission of the appropriate regulatory agency.

Our interpretation of the legislative history of Section 441(a) is confirmed by the General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172 (1970), prepared by the Staff of the Joint Committee on Internal Revenue Taxation. Referring to the third rule which applies to existing property under Section 441(a) as finally enacted, the General Explanation states (p. 151):

> If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so (except for a special election procedure discussed below), unless the appropriate regulatory agency permits a change as to that property.

And with respect to new property, the explanation states that a utility on flow-through must remain on flow-through "unless the regulatory agency permits it to change (or unless the election below applies)" (*ibid.*).

The court of appeals refused to accept these summaries as accurate reflections of the legislative intent in enacting Section 441(a) on the ground that the language was lifted largely from the House and Senate reports (Pet. App. 47-49). The specific references in the General Explanation to the right of election and the subsequent discussion of the right of election, including the observation that it applies only to expansion property (General Explanation, p. 152), however, show that the Staff fully considered the impact of the Conference amendment and correctly concluded

that the Conference did not depart from this area of agreement in the House and Senate bills. The General Explanation thus provides further contemporary and solid evidence that regulatory agency authority to permit abandonments of flow-through was not impaired by the addition of a provision giving utilities the absolute right not to have flow-through apply to their expansion property.

2. The court below also emphasized the statements in the House and Senate reports that the proposed legislation was intended to "freeze" the current situation regarding methods of depreciation (Pet. App. 34–36). This emphasis is misplaced and does not support the decision below. The House report, after discussing the loss of tax revenues occasioned by shifts by utilities from straight-line to accelerated depreciation and shifts from normalization to flow-through, states (H. Rep. No. 91–413, *supra*, pp. 132–133):

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Also, this would result in prompt, substantial, and widespread utility rate increases.
>
> Accordingly, your committee has determined in general to "freeze" the current situation regarding methods of depreciation in the case

> of those companies in what are, by and large, the more healthy utility industries. * * *

Similarly, the Senate report discusses the loss of tax revenues from shifts in depreciation methods and then states (S. Rep. No. 91–552, *supra*, p. 172):

> * * * [A] rule requiring all * * * utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.
>
> Accordingly, the committee agrees with the House that it is appropriate to in general "freeze" the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries.

The "freeze" envisioned by Congress, then, was intended (1) to forestall switches to faster methods of depreciation or from normalization to flow-through, (2) to guard against "prompt, substantial and widespread" rate increases and (3) to avoid putting some utilities at a competitive disadvantage. But, as is clear from both the House and Senate versions of the legislation and from both the House and Senate reports,

the "freeze" was not intended to be absolute. Only shifts from straight-line to accelerated depreciation or from normalization to flow-through on existing property were prohibited. Otherwise, the elimination of the threat of immediate and widespread rate increases and the desire not to force some utilities into a competitively disadvantageous posture were accomplished, not by an absolute freeze on existing practices, but by not forcing the abandonment of flow-through or changes to straight-line depreciation and leaving such matters to the discretion of the regulatory agencies. In other words, while Congress imposed a "freeze" so that utilities would not be required to abandon flow-through, it did not deny regulatory agencies the authority to determine whether in particular instances the abandonment of flow-through by a utility would be in the public interest.[11]

II

THE COMMISSION'S ACTION IN PERMITTING TEXAS GAS TO CHANGE FROM FLOW-THROUGH TO NORMALIZATION WITH RESPECT TO ITS EXISTING AND REPLACEMENT PROPERTY WAS PROPER AND SHOULD BE AFFIRMED WITHOUT FURTHER PROCEEDINGS IN THE COURT OF APPEALS

In holding that the Commission lacked the power to permit Texas Gas to abandon flow-through with respect to existing and replacement property, the court of appeals did not reach the question whether,

[11] For a thorough analysis of the derivation of the qualified "freeze" concept explained in the House and Senate reports, see the brief on the merits of Texas Gas in these cases at pp. 47-53.

assuming the Commission did have the power, its action in this case was proper. If the Court agrees with us that Section 441(a) of the Tax Reform Act of 1969 did not deprive the Commission of authority to permit abandonments of flow-through, the scope of judicial review of the Commission's exercise of that authority is very limited (see pp. 15–18, *supra*). The Commission's opinions in Nos. 578 and 578–A (Pet. App. 57–71) show that it acted well within its discretion in authorizing the change in Texas Gas' depreciation practices. Since there are no substantial issues requiring further consideration by the court of appeals, this Court should affirm the Commission's order on the merits.

When the Commission determined in 1964 in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, affirmed *sub nom. Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F. 2d 318 (CA. 5), certiorari denied, 385 U.S. 847, that utilities using accelerated depreciation in calculating their federal income taxes should flow-through the resulting tax benefits to their customers, it based its decision on two important assumptions: (1) that the supply of natural gas would continue to expand rapidly at least until the end of this century and would generate proportional increases in plant investment (31 FPC at 217–218), and (2) that as a result of the continued expansion of the natural gas industry, liberalized depreciation on new assets would more than counterbalance declining depreciation on older assets (*id.* at 215–216). Neither assumption is valid today.

With respect to the supply of natural gas, this Court just last Term referred to "a pattern of temporary and chronic natural gas shortages throughout the Nation." *Federal Power Commission* v. *Louisiana Power & Light Co.*, 406 U.S. 621, 626. See also *Texaco, Inc.* v. *Federal Power Commission*, C.A.D.C., No. 71-1560, slip op. at 6 (decided December 12, 1972); Federal Power Commission Staff Report No. 2, *National Gas Supply and Demand, 1971–1990*, pp. xi–xii, 1–38 (1972). Thus, the continued rapid expansion of the natural gas industry can no longer be taken for granted.

Even if the natural gas industry should continue to expand, however, the second *Alabama-Tennessee* assumption falls with respect to companies like Texas Gas which have elected to abandon flow-through with respect to their post-1969 expansion property. As we have noted (p. 10, *supra*), the Commission in Order No. 404 announced as a general policy that utilities making the election under Section 167(*l*)(4)(A) to abandon flow-through on their expansion property would be permitted to use normalization with respect to such property. In other words, Texas Gas, having made the election, now uses liberalized depreciation on its expansion property for federal income tax purposes, but uses straight-line depreciation on such property in determining its income tax expense on its books of account for ratemaking purposes.[11] Thus, for ratemaking purposes, the benefits of liberalized depre-

[11] The difference between what the company reflects on its books of account as its tax expense and the taxes the company actually pays is placed in a special, restricted reserve for the payment of future taxes.

ciation on the company's expansion property are no longer available in calculating the company's tax expense on its books of account to offset the effects of declining tax depreciation on the company's books of acount arising from the continued use of flow-through on existing property.

Nor would the continued use of flow-through on replacement property produce sufficient tax depreciation allowances to offset declining tax depreciation allowances on existing property. As the Commission noted in this case, the permissible tax depreciation life of natural gas properties in general is far shorter than the physical life of such properties (Pet. App. 63). Thus, replacements are relatively infrequent and may not be necessary until well after an asset is fully depreciated. As the result of the use of flow-through, the total depreciation on existing and replacement property as reflected in the tax expense item in a company's books of account (as distinguished from what would be reflected on the company's actual tax return) would steadily decrease relative to what the depreciation would have been under normalization and there would be no permanent deferral of taxes. Present consumers would thus be benefited at the unwarranted expense of future consumers (Pet. App. 65).

While the above observations apply to the natural gas industry in general, they also apply to Texas Gas in particular. A company executive testified at the hearing in this case that from 1970 to 1971 the tax depreciation on its existing property would decline by more than $1,100,000 (App. 17). He stated that, in

order to generate sufficient additional depreciation so that the dollar differential between tax depreciation and straight-line depreciation for 1970 would remain the same for 1971, the company would have had to invest $33,000,000 in new plant equipment (*ibid.*). And if the company were normalizing its tax depreciation for expansion property—as permitted by Commission Order No. 404—a $33,000,000 investment in replacement property would be required. While the record does not disclose what Texas Gas' actual investment in replacement equipment was in 1972, the annual reports of the company filed with the Commission (FPC Form 2) show that the company's average plant retirements from 1965 through 1969, valued at original cost, were $2.7 million per year. Even if all the retired equipment were replaced,[13] the value of the replacements would be but a fraction of the $33,000,000 needed to maintain the differential between tax depreciation under flow-through and straight-line depreciation. Since Texas Gas' tax de-

[13] The regulations under Section 167(*l*) specify alternate formulae for determining what portion of a company's new investments in any given year qualifies as post-1969 expansion property covered by the election under Section 167(*l*)(4)(A) and what portion constitutes replacement property subject to the general provisions of the statute. Under the formula used by Texas Gas (see Treas. Reg. 1.167(*l*)–4(c)), the maximum amount of its new investments in any one year which would not qualify as expansion property (*i.e.*, which would be considered replacement property) would be an amount equal to its plant retirements in that year. In 1969, for example, Texas Gas had retirements of $1.9 million (FPC Form 2) and net plant additions of $59.7 million (App. 41). Of the plant additions, only $1.9 million, at most, would be considered replacement property.

preciation on existing and replacement property as reflected in its books of account for ratemaking purposes would decline under flow-through relative to what it would be under normalization, the company's future customers would bear the burden of the present taxes temporarily deferred through the use of liberalized depreciation for tax purposes. This would not occur under normalization.

Under all the circumstances, the Commission acted well within its competence and authority in concluding that stable rates and the public interest would be promoted by permitting Texas Gas to use the same method of depreciation on all its property in calculating its federal income tax expense for ratemaking purposes.

CONCLUSION

Insofar as it set aside Opinions Nos. 578 and 578-A of the Federal Power Commission, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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FEBRUARY 1973.

APPENDIX

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 625, 26 U.S.C. 167 (*l*), provides:

(a) IN GENERAL. Section 167 (relating to depreciation) is amended by inserting after subsection (k) (added by section 521) the following new subsection:

"(*l*) REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

"(1) PRE-1970 PUBLIC UTILITY PROPERTY.—

"(A) IN GENERAL.—In the case of any pre-1970 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—

"(i) a subsection (*l*) method, or

"(ii) the applicable 1968 method for such property. Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

"(B) FLOW-THROUGH METHOD OF ACCOUNTING IN CERTAIN CASES.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

"(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

"(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

"(2) POST-1969 PUBLIC UTILITY PROPERTY.—In the case of any post-1969 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—

"(A) a subsection (*l*) method,

"(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

"(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) PUBLIC UTILITY PROPERTY.—The term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

"(i) electrical energy, water, or sewage disposal services,

"(ii) gas or steam through a local distribution system,

"(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

"(iv) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision

thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

"(B) PRE-1970 PUBLIC UTILITY PROPERTY.—The term 'pre-1970 public utility property' means property which was public utility property in the hands of any person at any time before January 1, 1970.

"(C) POST-1969 PUBLIC UTILITY PROPERTY.—The term 'post-1969 public utility property' means any public utility property which is not pre-1970 public utility property.

"(D) APPLICABLE 1968 METHOD.—The term 'applicable 1968 method' means, with respect to any public utility property—

"(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

"(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

"(iii) if neither clause (i) nor (ii) applies, a subsection (*l*) method.

In the case of any section 1250 property to which subsection (j) applies, the term 'applicable 1968 method' means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

"(E) APPLICABLE 1968 METHOD IN CERTAIN CASES.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (*l*) method) with respect to any public utility property in a timely application for change of

"(5) REORGANIZATIONS, ASSETS ACQUISITI
ETC.—If by reason of a corporate reorgani
tion, by reason of any other acquisition of
assets of one taxpayer by another taxpayer
reason of the fact that any trade or busi
of the taxpayer is subject to ratemaking
more than one body, or by reason of other
cumstances, the application of any provis
of this subsection to any public utility prope
does not carry out the purposes of this
section, the Secretary or his delegate shall
vide by regulations for the application of
provisions in a manner consistent with the
poses of this subsection."

(b) EFFECTIVE DATE.—The amendment m
by subsection (a) shall apply with respect
all taxable years for which a return has
been filed before August 1, 1969.

U.S. GOVERNMENT PRINTING OFFICE: 1970

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

Nos. 72-486 and 72-488

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

RESPONSE OF MEMPHIS LIGHT, GAS AND WATER DIVISION AND THE PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK IN OPPOSITION TO MOTIONS OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA AND FOUR ELECTRIC UTILITIES FOR LEAVE TO FILE BRIEFS AS AMICI CURIAE

To the Honorable, The Chief Justice of the United States and Associate Justices:

Memphis Light, Gas and Water Division (Memphis) and The Public Service Commission for the State of New York (New York), hereinafter collectively "Respondents", file this response in opposition to the sep-

arate motions of Independent Natural Gas Association of America (INGAA) and of four electric utilities[1] to file briefs as amici curiae in support of the Petitioners in Nos. 72-486 and 72-488.

Respondents declined to consent to the filing of a brief as amici curiae by the four electric utilities. Memphis also declined to consent to the filing of a brief as amicus curiae by INGAA. New York consented to the filing of a brief as amicus curiae by INGAA, but on review of INGAA's motion and brief believes the motion should be denied for the reasons hereinafter stated.

Rule 42(3) of the Rules of this Court requires that the motion for leave to file a brief as an amicus curiae shall, among other things, "set forth facts or questions of law that have not been, or reasons for believing that they will not adequately be, presented by the parties, and their relevancy to the disposition of the case . . . ."

Neither INGAA nor the four electric utilities come close to meeting the requirements of Rule 42(3). INGAA simply makes the bald, unsupported assertion (Motion, p. 3) that the interests of other INGAA members are not represented by Texas Gas Transmission Corporation, one of the Petitioners and an INGAA member, and by the other Petitioner, the Federal Power Commission. The four electric utilities assert (Motion, p. 2) that no electric utility is a party to the proceeding and, therefore, they "do not believe that any of the parties to these proceedings can properly be expected to demonstrate to this Court the effect the

[1] Jersey Central Power & Light Company, Metropolitan Edison Company, New Jersey Power & Light Company, Pennsylvania Electric Company.

decision of the Court below, if not reversed, will have upon electric utilities."

Examination of the briefs attached to the motions discloses only repetition of the arguments presented by Petitioners in 120 pages of briefs. In fact, the brief of the four electric utilities, despite the allegation in the motion quoted above, contains nothing specific concerning the alleged impact upon electric utilities, including the four electric utilities.

WHEREFORE, the motions for leave to file briefs as amici curiae should be denied.

Respectfully submitted,

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February 9, 1973.

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Section 441 . . . . . 5,6,7,8, 9,10,11

IN THE

Supreme Court of the United States

October Term, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF FOR RESPONDENT AMERICAN PUBLIC GAS ASSOCIATION*

STATEMENT OF THE CASE

A. Background

The passage of Section 167 of the Internal Revenue Act of 1954 raised the issue for regulatory bodies regarding the proper ratemaking treatment of tax savings effected through the use of liberalized (accelerated) depreciation.[1] Prior to the issuance in 1964 of Opinion No. 417 in *Alabama-Tennessee Natural Gas*

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*The American Public Gas Association (APGA) is the national association of municipal gas distribution systems.

[1]Congress enacted section 167 as an investment incentive for the business community generally. It enables taxpayers to write off between two-thirds and three-quarters of post-1933 investments in the first half of a property's estimated life.

Co.,[2] the Federal Power Commission (FPC or Commission) had taken the view that section 167 mandatorily required the Commission to permit affected natural gas companies to compute their taxes for ratemaking purposes on the basis of straight line depreciation even though their actual taxes were computed on the basis of liberalized depreciation. This so-called "normalization" accounting procedure resulted in rates to gas consumers which reflected a higher tax component than the companies actually paid. Thus, as the Commission noted in its *Alabama-Tennessee* opinion, in the nine years that liberalized depreciation reductions were available, "the natural gas pipelines and electric utilities have, respectively, accumulated $286,320,000 and $540,690,000 of deferred tax funds."[3] The Commission emphasized in its *Alabama-Tennessee* opinion that it had heretofore permitted normalization by natural gas companies based on the misconception that it was acting in accord with the Congressional mandate of section 167 of the Tax Act.[4] Once the Commission was disabused of this erroneous legal notion by various U.S. Courts of Appeals,[5] it reached for the first time the issue of "the proper ratemaking treatment for Alabama-Tennessee and other regulated companies which claim the benefits of liberalized depreciation on their tax returns."[6]

Freed from the imagined restraints of the 1954 Tax Act, the Commission looked to the statutory requirements of the Natural Gas Act, stating as follows:[7]

> We are, therefore guided in our determination by two fundamental considerations which are basic to the determination of just and reasonable rates under

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[2] Alabama-Tennessee Natural Gas Co., 31 F.P.C. 208, 928 (1964), *aff'd*, 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847.

[3] 31 F.P.C. at 209 (footnote omitted).

[4] 31 F.P.C. at 211-12. *E.g.*, Amere Gas Util. Co., 15 F.P.C. 760 (1956).

[5] Panhandle Eastern Pipe Line Co. v. FPC, 316 F.2d 659 (D.C. Cir. 1963), *cert. denied*, 375 U.S. 881; City of Lexington, Ky. v. FPC, 295 F.2d 109 (4th Cir. 1961); El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912.

[6] 31 F.P.C. at 210.

[7] 31 F.P.C. at 214 (emphasis added).

the Natural Gas Act. *First is the rule of law that only the amount of Federal income taxes actually payable if a reasonable return is earned can be included as an operating expense to be covered by the utilities' rates.* As early as 1922 the Supreme Court in the case of *Galveston Electric Co.* v. *Galveston*, 258 U.S. 388 (1922) ruled that rates should cover as an operating expense " * * * all taxes which would be payable if a fair return were earned * * * " (p. 399)

Another consideration basic to our determination herein is our statutory responsibility under the Natural Gas Act to assure that natural gas is sold in interstate commerce for resale at the lowest reasonable rate consistent with the maintenance of adequate service. As the Supreme Court recently stated in *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (1959):

> The purpose of the Natural Gas Act was to underwrite just and reasonable rates to the consumers of natural gas. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). As the original § 7(c) provided, it was "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption for domestic, commercial, industrial, or any other use at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." 52 Stat. 825. The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.

The Commission then addressed itself to "the practical consequences of the use of liberalized depreciation."[8] The Commission found that the natural gas companies and electric utilities participating in the proceeding had presented no factual basis to support their thesis of tax deferral, i.e., that the use of section 167 must result in an increase in future taxes equalling

[8] 31 F.P.C. at 215.

the reduction of present taxes.[9] On the other hand, the Commission agreed with the testimony and exhibits of Melwood Van Scoyoc which, as the Commission found, established:

> * * * that the use of liberalized depreciation deductions produced a tax saving; that flow-through of these savings to consumers would not burden future taxpayers; and that such flow-through resulted in stable rates and did not impair the financial integrity of the company or adversely affect its ability to attract capital for plant expansion.[10]

On review, the United States Court of Appeals for the Fifth Circuit upheld in full the Commission's decision to require flow through of the tax savings resulting from liberalized depreciation.[11] As to the effect of section 167 of the 1954 Tax Act, the Court cited with approval the following excerpt from the Commission's brief:[12]

> *El Paso Natural Gas Company* [and other cases] "purged [the Federal Power Commission] of the erroneous legal view which it had previously believed compelled a contrary result" and "freed the Commission's hand to make the instant reevaluation of the problem."

And as to the effect of the Natural Gas Act upon the issue of the proper treatment of the tax savings effected by liberalized depreciation, the Court stated as follows:[13]

> Under the flow-through treatment of liberalized depreciation, *the ratepayers reimburse the utility for federal income taxes the regulated utility actually pays.* The utility does not accumulate capital funds

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[9] *Id.*

[10] *Id.*

[11] Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir. 1966).

[12] *Id.* at 330.

[13] *Id.* at 327 (emphasis added).

that are, in effect, enforced contributions from consumers. Flow-through is in accord with *the established principle the Commission has "consistently held that consumers should be charged for only the actual liability for Federal income taxes.* * * *" United Fuel Gas Company, 12 F.P.C. 251, 264-65 (1953).

The Court emphasized that under accepted regulatory concepts, "utility company shareholders (investors), not the consumers, furnish the capital necessary for the operation of the business."[14] Thus since liberalized depreciation creates a tax saving for the natural gas industry, to permit normalization would improperly have the effect of requiring the gas consumers not only to pay a fair return on the utility's capital but also to contribute part of that capital.[15] The U.S. Supreme Court denied ceriorari.[16]

The commission continued, consistent with the "actual taxes paid" principle of the Natural Gas Act, to require flow through (even of companies which switched back to straight line depreciation[17]) until the present litigation began following enactment of the Tax Reform Act of 1969.

B. The Proceedings Below

Following enactment of § 441 of the Tax Reform Act of 1969 which *inter alia* permitted affected utilities using flow through the option *with regard to post-1969 expansion property only* to switch to straight line depreciation or with the approval of the appropriate regulatory body, to switch to normalization, the Commission on May 15, 1970, issued Order No. 404 ("Statement of Policy", Docket No. R-387)[18] per-

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[14] *Id.* at 327 (citations omitted).

[15] *Id.* at 327-28, 336-39.

[16] Alabama-Tennessee Natural Gas Co. v. FPC, 385 U.S. 847 (1966).

[17] *E.g.*, Midwestern Gas Transmission Co., 36 F.P.C. 61, 599 (1966), *aff'd*, 388 F.2d 444 (7th Cir. 1968), *cert. denied*, 392 U.S. 928 (1968).

[18] 43 F.P.C. 740 (1970).

mitting "electing" utilities under its jurisdiction to switch to normalization as to post-1969 expansion property. The Commission reasoned that since the affected utilities had the automatic statutory right to switch to straight line as to post-1969 expansion property and since normalization was more favorable to consumers than straight line,[19] it was in the public interest to allow normalization. Thus Order No. 404, which was affirmed by the court below, is not inconsistent with the "actual taxes paid" principle of the Natural Gas Act in that it allowed a deviation from flow through *only* as to that property (i.e. post-1969 expansion property) as to which utilities had an automatic right under § 441 of the 1969 Tax Reform Act to switch to straight line depreciation or with the approval of the appropriate regulatory body, to normalization.

In its Opinion No. 578 issued on June 3, 1970 in *Texas Gas Transmission Corp.*,[19a] however, the Commission went beyond the terms of the § 441 election provision and held that a utility like Texas Gas which had elected to switch to normalization with regard to post-1969 expansion property, could also abandon flow through and use liberalized depreciation with normalization as to pre-1970 and post-1969 non-expansion property, in direct violation of the "actual taxes paid" principle of the Natural Gas Act. In arriving at this result, the Commission, citing the House Report, found that the 1969 Tax Act did not affect its authority to reach such a result.[20]

On appeal,[21] the U.S. Court of Appeals for the D.C. Circuit reversed the Commission on the grounds, *inter alia*, that Congress intended in the 1969 Tax Act that the right of election should be limited to post-1969 expansion property

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[19]Though the calculation of the tax expense is the same under straight line as normalization, under the latter method the deferred tax expense is subtracted from rate base. The saving is slight in comparison to that effected by the use of flow through.

[19a]43 FPC 824 (1970).

[20]J.A. 107.

[21]Memphis Light, Gas & Water Div. v. FPC, 462 F.2d 853, *aff'd on rehearing*, 462 F.2d 865 (D.C. Cir. 1972).

only and that the Commission's attempt to go outside the scope of § 441 of the 1969 Tax Act by permitting the switch from flow through to normalization as to *all* property violated (a) the clear intent of Congress to limit the right of election to post-1969 expansion property only[22] and (b) the "actual taxes paid" principle of the Natural Gas Act.[23] The Court arrived at its former conclusion after a thorough and detailed study of the legislative history of the 1969 Tax Act, which revealed that as the tax bill finally emerged from conference, the 180-day election provision was applicable to post-1969 expansion property only and that the provision cited in the House Report and relied upon by the FPC in Opinion No. 578 as authority for allowing a switch to normalization for all property was effectively superseded by the terms of the election provision. In other words, the election provision was inserted to effect a "freeze" of the existing situation by permitting utilities to switch gradually to normalization with regulatory approval as to post-1969 expansion property only; the election provision was not inserted to form the springboard for the wholesale switch to normalization with regulatory approval as to all property.[24] The Court found that such a springboard approach "would be to undo what was most carefully done."[25]

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[22] 462 F.2d at 863.

[23] 462 F.2d at 863-64: "There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property."

[24] It is not disputed that the switch from flow through to normalization for *all* property, if permitted, would result in utilities collecting scores of millions of dollars annually from consumers via increased rates.

[25] 462 F.2d at 870.

ARGUMENT

I

THE COURT BELOW ACCURATELY ANALYZED THE LEGISLATIVE HISTORY OF THE 1969 TAX REFORM ACT AND CORRECTLY CONCLUDED THAT CONGRESS IN SPECIFICALLY LIMITING THE 180-DAY ELECTION PROVISION TO POST-1969 EXPANSION PROPERTY INTENDED TO PRECLUDE REGULATORY AGENCIES FROM AUTHORIZING A SWITCH TO NORMALIZATION AS TO ALL PROPERTY.

The main argument of the Commission (Br. 19-29) and of Texas Gas (Br. 15-36) is that though § 441 of the 1969 Tax Reform Act gave the affected utilities the new right as to post-1969 expansion property to elect within 180 days to switch from flow through to straight line or with the approval of the appropriate regulatory body, to normalization, the 1969 Tax Act did not thereby limit the right of such utilities to seek to switch *at any time* from flow through to normalization as to all property with the consent of the appropriate regulatory body. This tortured construction of the Tax Act produces the absurd result that whereas it is clear that Congress was specifically setting aside post-1969 expansion property for special treatment (i.e. the 180-day election period), under the Commission's and Texas Gas' view the election as to post-1969 expansion property may be used as the springboard to permit the switch from flow through to normalization as to *all* other property *at any time*. The simple answer to this contention is that if Congress had intended this result, it would have so provided rather than isolating one type of property for special treatment. But as the Court below went to such lengths to demonstrate in its treatment of the legislative history of § 441 of the Tax Act, Congress meant what it said when it limited the right of election to post-1969 expansion property only. As the court below so aptly phrased it (462 F.2d at 863),

> What the Commission does by its decision in this set of cases, then, is to produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969.

With regard to the futile attempt by the Commission and Texas Gas to find fault with the Court of Appeals' thorough analysis of the Tax Act's legislative history, not only is such attempt analytically deficient[26] but even more importantly, it completely misses the point, which is that if § 441 is not construed as the Court below suggests, then you "produce an effect precisely contrary to that envisioned by Congress in enacting the Tax Reform Act of 1969." *Ibid.* In other words, if Congress had intended to open the door to a wholesale switch by natural gas, electric and other utilities from flow through to normalization as to *all* their property with regulatory approval, it would not have chosen the devious path of permitting a limited election within 180 days as to post-1969 expansion property only; rather it would have adopted the House version of the bill, which would have permitted exactly that result. See chart of legislative history, 462 F.2d at 866. The fact that it made two key changes to the House version, i.e. (1) limited the period for election to 180 days and (2) limited the property subject to election to post-1969 expansion property, demonstrates conclusively that Congress did not intend for regulatory agencies to use the limited election provision as the stepping stone for an across-the-board abandonment of the flow through method. To repeat, had Congress intended this result, it would have so legislated.

Another point glossed over by Petitioners is why, if Congress intended for utilities to have a continuing right to seek to switch from flow through to normalization with regulatory approval as to *all* property, it limited that right in § 441(a) to post-1969 expansion property to be exercised within 180 days.[27] In other words, according to Petitioners, Congress performed an empty act in § 441 by permitting utilities to seek to switch within 180 days to normalization with regulatory approval as to post-1969 expansion property, because they have the same right as to *all* property at *any* time anyhow. The Court

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[26] In our view, the Court's analysis speaks for itself and will not be repeated here.

[27] The FPC does not appear to address this issue at all; Texas Gas' attempt to explain the "overlap" (Br. pp. 23-26) is unpersuasive.

of Appeals correctly determined that Congress was not performing an empty act in its careful wording of the election provision and thus that it could not be used as the springboard for a wholesale switch to normalization as to all property at any time, resulting in multi-million dollar rate increases.

II

THE COURT BELOW PROPERLY RULED THAT THE ATTEMPTED SWITCH TO NORMALIZATION AS TO PRE-1970 AND POST-1969 NON-EXPANSION PROPERTY VIOLATED THE "ACTUAL TAXES PAID" PRINCIPLE OF THE NATURAL GAS ACT WHICH WAS LEFT IN TACT BY THE 1969 TAX ACT.

Though we are confident that the Supreme Court will affirm the Court of Appeals construction of the 1969 Tax Reform Act, it is important to note also that even assuming *arguendo* that Petitioners are correct in their contention that the 1969 Tax Act did not affect the authority of agencies like the FPC to permit normalization as to pre-1970 and post-1969 non-expansion property, the FPC's decision to allow normalization as to that property not specifically covered by the election provision violates the established "rule of Law" under the Natural Gas Act that consumers must reimburse natural gas companies only for their "actual taxes paid",[28] as the Court of Appeals found (462 F.2d at 863-64):

> There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow through with respect to their pre-1970 and post-1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property.

And there can be no dispute that the normalization method (pursuant to which a utility's taxes for ratemaking purposes are computed as though straight line depreciation were being used)

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[28] *E.g., Alabama-Tennessee, supra*, 31 F.P.C. at 211-12.

produces a tax component *above* the actual taxes paid by the affected utility.

The Commission's brief (pp. 3-6, 29-34) attempts to give the impression that the Commission's decision in the landmark *Alabama-Tennessee* case was dictated by circumstances which no longer prevail today and that thus it may be discarded like yesterday's newspaper without so much as a reference to the "actual taxes paid" principle of the Natural Gas Act.[29] However, as the discussion in the statement of the case shows,[30] the Commission in *Alabama-Tennessee* recognized that the "acutal taxes paid" principle of the Natural Gas Act *requires* flow through of the tax benefits accruing from the use of liberalized depreciation, and the only reason that the Commission waited until 1964 to reach that result was that prior to that time it was under the mistaken impression that § 167 of the Internal Revenue Code required normalization (i.e. superseded the "actual taxes paid" principle of the Natural Gas Act).

The Commission's brief (pp. 30-31) cites as the first changed circumstance the present gas supply situation. But the Commission declines to link this up to the key finding in *Alabama-Tennessee* that liberalized depreciation created a permanent tax deferral for a utility with a stable or expanding plant.[31] Not only does the Commission's brief not cite any evidence or finding from the proceeding below that there is a decline in plant investment, but even more telling, the Commission's brief (p. 31) can only conclude weakly (and completely irrelevantly) that "the continued rapid expansion of the natural gas industry can no longer be taken for granted." In brief, the Commission made no findings below (for the good reason that there was no record evidence) that plant additions would not continue to be sufficinet to create a tax saving rather than a tax deferral as the result of the use of liberalized depreciation.

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[29] Texas Gas (Br. pp. 4-5, 62-65) pretends as though the "actual taxes paid" principle does not exist and that the question of what type of depreciation is used is purely a discretionary matter. Texas Gas errs.

[30] Pp. 1-5, *supra*.

[31] 31 F.P.C. at 216.

The second so-called changed circumstance raised in the Commission brief (pp. 31-32) is that since Texas Gas has elected to switch from flow through to normalization as to expansion property for ratemaking purposes, the benefits of liberalized depreciation on such property are no longer available in calculating the company's tax expense on its books of account to offset the effects of declining tax depreciation on the company's books of account arising from the continued use of flow through on existing property. The obvious and fatal flaw in this argument is that Texas Gas did not make its switch re post-1969 expansion property until after it got FPC assurance that it would be allowed to make the switch as to all property.[32] Thus it is sheer makeweight for the Commission to argue that it was in effect forced to allow Texas Gas to use normalization as to all property because Texas Gas had the unexercised right under Order 404 to switch to normalization for post-1969 expansion property. The Commission's abandonment of the established "actual taxes paid" principle by reason of Texas Gas' "proposed election"[33] under the Tax Act is clearly contrary to the letter and spirit of the Natural Gas Act which "was so framed as to afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges."[34]

At most, an equitable argument can be made that since the FPC's Opinion No. 578 allowing the switch to normalization as to pre-1970 and post-1969 non-expansion property is unlawful under the Tax Act and the Natural Gas Act, Texas Gas which relied on Opinion No. 578 should be allowed to revoke its election under the Tax Act as to post-1969 expansion property and continue to flow through as to such property.

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[32] Texas Gas Br. p. 7.

[33] J.A. 108.

[34] Atlantic Refining Co. v. P.S.C. of New York, 360 U.S. 378, 388 (1959).

CONCLUSION

For the foregoing reasons, the opinion of the Court of Appeals reversing Commission Opinions No. 578 and 578-A should be affirmed.

Respectfully submitted,

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK, RESPONDENT

OPINIONS BELOW

The initial opinion of the court of appeals (Pet. App. 1-39)[1] and its opinion on rehearing (Pet. App. 41-53) are reported at 462 F. 2d 853, 865. The initial opinion (No. 578) of the Federal Power Commission (Pet. App.

[1] "Pet. App." references are to the appendices to the petition in No. 72-486.

57-66) and its opinion on rehearing (No. 578-A; Pet App. 67-71) are reported at 43 FPC 824 and 44 FPC 140.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972 (Pet. App. 55-56), and the Commission's petition for rehearing was denied on May 11, 1972 (Pet. App. 41-53). On August 4, 1972, the Chief Justice extended the time for filing petitions for writs of certiorari to September 23, 1972. The petitions were filed on September 22, 1972. On December 6, 1972, the Court granted both petitions and consolidated the cases. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that Section 441(a) of the Tax Reform Act of 1969, which both the House and Senate Reports stated was intended in general to "freeze" the existing situation regarding methods of depreciation by regulated utilities, precluded the pipelines from increasing their rates by switching from a "flow through" to a "normalized" method of treating their use of liberalized depreciation with respect to their pre-1970 and non-expansion property which was expressly excluded from a 180 day election period provided for seeking agency approval of such changes in pipeline operation.

2. If the Tax Reform Act of 1969 did not restrict a pipeline's authority to seek permission from the Federal Power Commission to increase its rates by shifting from flow through to normalization treatment with respect to

its pre-1970 property, whether the Commission's approval of Texas Gas' shift here was justified under the standards of the Natural Gas Act and the factual record upon which the Commission could ground its decision.

STATUTE INVOLVED

Section 441 of the Tax Reform Act of 1969, 83 Stat. 626, 26 U.S.C. 167(*l*), is set forth as an appendix to the brief for the petitioner, Federal Power Commission.

STATEMENT

The present case involves a successful effort by Texas Gas Transmission Corporation (Texas Gas) to increase its rates by approximately $4,400,000, over and beyond those approved by the Federal Power Commission to provide the revenues required by its cost-of-service including a reasonable return on its prudent investment. It did so by charging its customers as a tax expense the amount it would have paid in federal income taxes if it had utilized a straight line method of depreciation of its existing facilities when it in fact was utilizing the more rapid "liberalized depreciation" techniques authorized by Section 167 of the Internal Revenue Code. (The actual difference in taxes between utilizing straight line and liberalized depreciation would only have been about half of the $4,400,000 rate increase. But since the Internal Revenue Service treats the additional revenues as taxable income, the Commission authorized Texas Gas to increase its rates by an amount calculated to afford it the use *after taxes* of the entire difference between straight line and liberalized depreciation.)

The Commission Opinion (App. 100-111) grounded its approval of the change in Texas Gas' method of treating its use of liberalized depreciation with respect to its pre-1970 property upon the alleged change in circumstances caused by the enactment of the Tax Reform Act of 1969 and Texas Gas' exercise of the option provided by Section 441(a) thereof under which a pipeline previously utilizing liberalized depreciation with flow through may within a 180-day period after enactment of the Act elect to shift its method of handling the depreciation of its *post-1969 expansion property* either to straight line depreciation or, with the approval of the Commission, to liberalized depreciation with normalization. On review the Court of Appeals for the District of Columbia Circuit unanimously held that Congress, in limiting the election to new expansion property, had intended to freeze the existing situation with respect to a pipeline's use of liberalized depreciation for its pre-1970 property, and Texas Gas accordingly could not be authorized to switch to normalization from flow through for property on which it had been taking liberalized depreciation. In the light of this determination the Court below did not reach the other contentions raised by Memphis Light, Gas and Water Department (Memphis) and the Public Service Commission for the State of New York (New York) in their petitions for review of the Commission's order.

Background

Texas Gas is a major interstate pipeline providing service from the Gulf of Mexico to Ohio. It was originally certificated by the Federal Power Commission to construct and operate its system in 1949, *Texas Gas*

Transmission Corp., 8 FPC 191. During the initial years of its operation it was authorized to depreciate its plant for both book and tax purposes according to a so-called "straight line" method of depreciation under which the rate at which individual units of property are depreciated remains constant over the assets' life. Pursuant to standard regulatory precepts Texas Gas was authorized to include in its cost-of-service expense items covering both the annual depreciation charge and the cost of the federal income taxes which would be due on the taxable net income which would be produced at rates just covering its cost-of-service, including a fair rate of return on its invested capital. Such taxes, in turn, were calculated on a basis which, *inter alia*, permitted the pipeline to deduct its depreciation expenses.

In 1954 Congress adopted Section 167 of the Internal Revenue Code of 1954, 68A Stat. 51. This section added a permanent feature to the federal tax laws,[2] under which qualifying companies, including natural gas pipelines subject to the regulatory authority of the Federal Power Commission were authorized in calculating their taxable income to utilize any one of several methods of accelerated depreciation under which the rate of depreciation on particular items of property is lower in the earlier years than it would be under the straight line method, but higher during the later years of its operation.

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[2]Section 167 of the Code, *supra*, is to be contrasted with Section 168, 26 U.S.C. 168, originally adopted as Section 218 of the Revenue Act of 1950, as an emergency measure to encourage defense plant expansion during the Korean War, under which certain specified types of essential facilities were for a limited time certificated as eligible for accelerated amortization for tax purposes.

We discuss in some detail in the body of the Argument (pp. 32-35) the history of commission and judicial action subsequent to the enactment of Section 167. After the Commission decided in *Amere Gas Utilities*, 15 FPC 760, that pipelines could normalize the use of liberalized depreciation in their accounts—*i.e.*, charge as a tax expense the higher amount the company would have paid if it had been utilizing straight line instead of liberalized depreciation—Texas Gas in 1955 began utilizing liberalized depreciation with normalization. The result was the gradual but steady build up of a fund in Account No. 282 which by the end of 1969 had reached the amount of $12,993,064.

Initally, Texas Gas was permitted to earn a full return on fund; after the commission's decision in *Northern Natural Gas Co.*, 25 FPC 431, it earned 1-½% on the accumulated fund. However, in 1966, after the Commission in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, concluded that for growing or stable pipelines the use of liberalized depreciation involved a tax savings which should be "flown through" to the pipeline's customers, Texas Gas was required to flow through the benefits of its use of liberalized depreciation. Texas Gas, however, exercised the option provided to all pipelines in *Alabama-Tennessee* of maintaining intact the funds already accumulated in Account No. 282 for use in the future should, contrary to the Commission's predictions, the use of liberalized depreciation cease to involve tax savings.

The Proceeding Before the Commission

On June 27, 1969 Texas Gas filed with the Commission a proposed change in its rates and charges which would have increased its rates by an estimated

$36,813,407 annually (App. 57). Among the reasons given by Texas Gas for this proposed increase was "the proposed discontinuance of the use of liberalized depreciation and the reversion to a straight line method of tax depreciation" (App. 53). On August 11, 1969 the Commission suspended the effectiveness of the rate filing until January 12,1970 and set the matter for hearing (App. 64-70), indicating in its order that certain issues might be appropriate for early hearing and resolution, and authorizing the Examiner to phase the hearing so that such issues could be promptly disposed of. Pursuant to this directive the Examiner directed that the hearing be held in stages with "Phase 1 to cover the issues with respect to rate of return and principles applicable to the use of straight line versus accelerated depreciation" (App. 82). Hearing on these two issues was held on December 9, 1969 (App. 84). On this latter date the staff counsel, with the concurrence of all parties in attendance, moved that the intermediate decision of the Examiner in Phase I be omitted and the record transferred to the Commission for its immediate decision on the two issues on which testimony had been taken (App. 81). This motion was granted by the Commission on December 23, 1969 (App. 82).

Throughout this entire period Texas Gas did not suggest that, depending upon the outcome of the tax bill then pending in Congress, it might seek to modify its position to seek to remain on liberalized depreciation but utilize normalization for either its existing or future facilities. Nor did it so indicate in its brief on Phase I of the case filed with the Commission on January 16,1970, over two weeks after the Tax Reform Act of 1969 was approved by the President. Instead it argued that the passage of the Act required approval of its proposed

switch to straight line depreciation for its existing plant since its proposed exercise of its election under the 180-day option provision of the Act to use normalization on its future plant allegedly would eliminate the tax savings effect of continuing to use liberalized depreciation (App. 88).

On May 4, 1970, Texas Gas filed a motion with the Commission—which had not yet acted on the Phase I issues—asking for expedited decision on the limited issue of tax depreciation (App. 90-94). It gave as a reason for this request the fact that the 180-day option provided by the Tax Reform Act for switches from liberalized depreciation with flow through with respect to new post-1969 property would expire on June 29, 1970 and that "before making this election, however, Texas Gas needs assurance from the Commission that it will be permitted to discontinue the use of liberalized depreciation for rate making purposes with respect to existing plant" (App. 92). However, on May 22,1972 (after the Commission had issued its Order 404, discussed below) counsel for Texas Gas wrote a letter to the Commission, in purported response to a "question raised by a customer-intervenor" in which, for the first time Texas Gas stated that "if the Commission permits Texas Gas to use normalization for rate making purposes" it proposed to continue the utilization of liberalized depreciation with normalization with respect to its "pre-1970 public utility property" as well as on the new property which was the subject of its proposed election (App. 97-98).

On May 15, 1970 the Commission issued, without notice or hearing, a Statement of Policy in Order 404, 43

FPC 740,[3] in which it determined that it was in the public interest to allow natural gas companies exercising the 180-day election provided by the Tax Reform Act of 1969 with respect to post-1969 expansion property, to shift from the use of liberalized depreciation with flow through for such property to liberalized depreciation with normalization, for purposes of both accounting and rate making.[4] And on June 3, 1970 the Commission issued its Opinion 578 here under review (App. 103-111), which authorized Texas Gas to utilize liberalized depreciation with normalization for accounting and rate making purposes "with respect to its property other than that subject to election under Section 167[*l*](1)(4)(A) of the Internal Revenue Code as amended by Section 441 of the Tax Reform Act of 1969" (App. 111). It did so primarily on the grounds that Texas Gas' exercise of its statutory election to normalize with respect to post-1969 property would mean that its continued use of liberalized depreciation on its pre-1970 property, and non-expansion additions or replacements thereof, would cease to involve a tax savings and therefore its previous basis for requiring flow through with respect to such property had ceased to exist (see, *e.g.*, App. 108-109).

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[3] *Calculation of Taxes for Property of Public Utilities, Licenses and Natural Gas Pipeline Companies Constructed or Acquired After January 1, 1970*, 43 FPC 740 (hereinafter "Order 404").

[4] This action of the Commission was the subject of appeals by Memphis and the Tennessee Valley Municipal Gas Association, and the court below affirmed the Commission in the same opinion here under review. A petition for certiorari of this aspect of the court of appeals decision was denied by this court on October 16, 1972. *Memphis Light, Gas and Water Division v. Federal Power Commission, et al.*, No. 72-96.

Nine days after the issuance of Opinion 578, on June 12, 1970, Texas Gas filed a motion for approval of a "settlement" of all other phases of its rate increase proceeding, including the rate-of-return issues which had been tried as part of Phase I of the case (App. 112-117). New York, which was not a party to the so-called settlement agreement, objected to its approval (App. 123-124). New York pointed out, *inter alia*, that the Commission's approval of the use of liberalized depreciation with normalization of Texas Gas' existing plant in Opinion 578 had been predicated in part upon the fact that this action would improve the company's before tax coverage of interest and its cash flow problem, and that it was inappropriate to consider the 8% rate-of-return allowance for Texas Gas which underlay the settlement without consideration of the additional $4,400,000 tax allowance it had just authorized in Opinion 578, since such an allowance "bears many of the attributes of return" (App. 124). The Commission, however, approved the settlement by Order of July 17, 1970 (App. 137-145), rejecting New York's contentions on grounds that the additional $4,400,000 tax allowance for Texas Gas did not represent return since the funds accumulated in Account 282 representing the difference between the taxes it actually paid and those it booked for rate purposes, would not be available for transfer to surplus or payout in dividends, and would be deducted from rate base in rate cases (App. 144).

New York (App. 125-129) together with Memphis (App. 118-122) and the Philadelphia Gas Works Division of the UGI Corporation (App. 133-136) petitioned for rehearing of Opinion 578, pursuant to the provisions of Section 19(a) of the Natural Gas Act, 15 U.S.C. §717(r

On July 21, 1970 the Commission issued its Opinion No. 578-A (App. 145-149) which denied the petitions in all respects.

The Proceedings in the Court Below

Petitions for Review of Opinion 578 were filed in the Court of Appeals for the District of Columbia Circuit by both Memphis and New York. On February 18,1972 the Court (Judges Fahy, Robinson and Wilkey) reversed the Commission. In an opinion by Judge Wilkey the Court concluded that, consistent with its intent to in general freeze the existing situation, the Congress limited the election provided to regulated utilities using liberalized depreciation with flow through to shift to either straight line depreciation or liberalized depreciation with normalization to expansion property acquired after January 1, 1970, and that this action precluded any shift from flow through to normalization on the utility's existing property (Pet. App. A, pp. 17-39). In view of this determination the court did not reach the other arguments advanced by Memphis and New York as to the validity of the Commission's action. On rehearing, the court reaffirmed its decision in a detailed supplemental opinion (Pet. App. B, pp. 41-53).

SUMMARY OF ARGUMENT

The Federal Power Commission in this case held that the exercise of the limited option, which Section 441 of the Tax Reform Act of 1969 provided to utilities to shift from a flow through to normalized manner of treating their use of liberalized depreciation for new expansion

property put into service after 1969, justified Texas Gas to similarly shift from flow through to normalization with respect to all of its existing property. The result of the Commission's action was directly the opposite of the Congressional intent to generally freeze the existing situation with respect to utility methods of tax depreciation so as to prevent either widespread revenue losses to the treasury or immediate rapid price increases to utility customers. The court below correctly held that such action to abandon flow through accounting with respect to pre-1970 property was expressly precluded by Congress in the Tax Reform Act. But, even if this were not the case, the Commission's conclusion that the operation of the Tax Reform Act served to convert the use of liberalized depreciation by Texas Gas from a tax savings to a tax deferral, and that therefore it was appropriate to permit it to charge as a tax expense the higher amount it would have paid had it utilized straight line depreciation, is clearly lacking in merit.

1. The court of appeals correctly concluded that the Senate version of the tax bill provided a procedure under which utilities using liberalized depreciation with flow through would have 180 days to elect to seek to change their mode of depreciation on all of their property to straight line or normalization, and that the subsequent limitation of this election in conference to new expansion property had the effect of freezing the *status quo* with respect to a utility's old or non-expansion property. The petitioners' arguments that the election introduced into the bill by the Senate was intended to provide an additional avenue of relief to the utilities is inconsistent with the language of the Senate bill and unsupported by any statement of such an intent in the Senate report. Moreover, it necessarily depends upon the assumption

that the Congress adopted an "additional" avenue for permitting a shift from flow through to normalization which was more restrictive than the allegedly independent and continuing path for achieving the same objective, and that its subsequent limitation of the election was without significance.

The court of appeals construction of the Tax Reform Act is far more in keeping with the underlying Congressional intent in adopting Section 441 than the alternate construction of the petitioners. The main objective of Congress was to prevent any revenue losses to the Treasury by precluding utility or agency action to shift depreciation practices from straight line to liberalized depreciation or from normalization to flow through. Congress rejected proposed methods of achieving its revenue objectives which would require either widespread changes in existing utility practices or result in significant major rate increases during a period of inflation, opting instead for a system which both the Senate and House Committees stated would "in general freeze the current situation regarding methods of depreciation. . . ." Clearly action by the conference to limit the right of utilities to seek to abandon flow through to new expansion property, which would allow for gradual increase in tax revenues as eligible new plant comes into service, but preclude massive immediate rate increases like those approved here, was a move directly in line with these objectives.

2. While it has long been held that federal income taxes are an expense which can properly be recovered as part of a regulated utility's cost-of-service, the courts have consistently held that tax savings provided by the Congress to a utility must be reflected in the computation of such tax allowances, at least where Congress has

not expressly directed to the contrary. This is no less true with respect to a pipeline's use of liberalized depreciation. Though a number of the early court decisions refused to interfere with the Commission's original determination that pipelines could normalize the use of liberalized depreciation for both accounting and tax purposes, they did so because of their acceptance of the Commission conclusion that the use of liberalized depreciation resulted in a tax deferral for the pipeline rather than a tax savings. When it was recognized that a utility maintaining a growing or stable plant will secure a permanent tax savings from its use of liberalized depreciation, the Commission, with the approval of the courts, reverted to the controlling "actual taxes" doctrine.

The Commission opinions here do not suggest that Texas Gas will cease to maintain a growing or stable gas plant in the foreseeable future; on the contrary, the Commission concludes that its overall growth will continue. However, the Commission held that since Texas Gas will now be authorized to normalize with respect to its new expansion property, the lower taxes it pays on such property will not be available to offset the higher taxes it might have to pay on its existing property, and that therefore its continuing use of liberalized depreciation on such property will cease to involve a tax savings. This arbitrary bifurcation of the pipeline's facilities is nothing but a reversion to the discredited concept of evaluating the effect of liberalized depreciation on a unit by unit (or group of units) basis when in fact the pipeline's tax obligations will continue to be determined on a company wide basis.

While the additional amounts in Account 282 resulting from the use of normalization of Texas Gas' new expansion property, like the substantial existing amounts

in the reserve account which built up during the early period when Texas Gas was authorized to normalize its use of liberalized depreciation, will not be necessary to pay increased taxes as long as the system as a whole continues to grow or remain stable, they would be available in the unlikely event this situation were to cease to exist. Moreover, even it it were proper to consider the old plant in isolation, there is demonstrably no basis for the Commission's conclusion that future tax payers might have to pay higher tax allowances if Texas Gas continues to flow through the present tax benefits with respect to such property. Nor is there any basis in this record for concluding that Texas Gas should be permitted to charge a fictitious tax expense in order to improve its before taxes interest coverage or to increase its cash flow.

ARGUMENT

I.

THE COMMISSION LACKS AUTHORITY TO PERMIT PIPELINES WHICH HAD BEEN UTILIZING LIBERALIZED DEPRECIATION WITH FLOW THROUGH TO SWITCH TO NORMALIZATION WITH RESPECT TO THEIR EXISTING PROPERTY

The court of appeals in the decision here under review, found it unnecessary to consider the various contentions raised by Memphis and New York below as to why they felt that the Commission's action approving Texas Gas' effort to increase its rates by shifting to a normalized treatment of the liberalized depreciation it continues to take on its existing plant was invalid in its own terms. For the court concluded that Congress in the Tax Reform Act of 1969, in aid of its general objective of freezing the existing situation with respect to utility depreciation

practices, had deliberately precluded any such shifts. This result, the court of appeals concluded, had come about as a result of action by the Senate to specify that moves by regulated companies presently utilizing liberalized depreciation with flow through either to straight line depreciation or normalization would have to be accomplished within a 180-day period, and the subsequent limitation of this election to any utility's new expansion property.

We show in this part of our brief that the lower court's interpretation of the effect of the Tax Reform Act of 1973 was correct as a matter of statutory construction and is far more consistent with the dual objectives of the Congress of preventing revenue losses to the treasury without causing any substantial rate increases than that which would necessarily result from acceptance of the contrary views pressed by the petitioners.

A. The Court of Appeals Correctly Concluded That the Restriction of the Election To Shift From Flow Through to New Expansion Property Eliminated the Commission's Discretion To Authorize Such Shift on Old Existing Property

The court of appeals concluded (Pet. App. 31-33) that, while the House bill authorized a utility which had been taking liberalized depreciation and flowing through the savings to its customers, to shift, with the permission of the Commission, to either straight line depreciation or liberalized depreciation with normalization, the Senate had limited the utility's option to seek such changes in its methods of operation to an 180-day election period. Since this election admittedly was curtailed in conference so as to apply only to post-1970 expansion property, the court below reasoned that a utility's right to switch from

flow through to normalization was in turn limited to such new expansion property. As to pre-1970 property or new property which did not increase "the productive or operational capacity of the company," the situation was "frozen" and no shifts from flow through permitted.

The Commission and Texas Gas, in taking issue with this position, do not dispute either the power of Congress in a tax bill to restrict the authority of the Commission and other regulatory agencies in the exercise of their rate making authority[5] or the fact that Congress in other respects restricted agency regulatory action in Section 441 of the Tax Reform Act of 1969. But they argue vigorously that the 180-day election feature introduced into the bill by the Senate was an "additional" form of relief provided to the utilities, separate and distinct from their preexisting right under the House bill to switch from flow through to straight line, or normalization with the permission of the Commission. They argue that the election's subsequent restriction to new expansion property did not affect the separate and continuing right of the utility to seek permission from the Commission to switch to straight line or normalization on its old or non-expansion property.

There is nothing in the language of either the Senate bill or subsequent Act which supports the treatment of

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[5]See, *e.g.*, Section 203(e) of the Revenue Act of 1964, 78 Stat. 35, which with respect to the Investment Tax Credit stated that "Congress does not intend that any agency or instrumentality of the United States . . . shall, without the consent of the taxpayer, use [the credit] to reduce such taxpayer's federal income taxes for the purpose of establishing the cost of service of the taxpayer or to accomplish a similar result by any other method."

the election as a separate additional remedy.[6] Consequently, in the absence of any clear statements in the Senate or Conference reports that this was Congress' intent, the petitioners have of necessity had to fall back upon language in the reports and the Joint Committee's General Explanation of the Act which is at best oblique and as the lower court's opinion points out (Pet. App. pp. 35, 49) contradicted by other statements in the same reports. But we do not believe that it is necessary for this court to involve itself in the at best unsatisfactory effort to glean significance from a syntactical analysis of the language of congressional reports. For acceptance of the contentions that the election was separate and distinct from the other provisions of the section, which allegedly

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[6]The most the Commission can glean from the language of Section 441 of the Tax Reform Act is that paragraph 1B of the new section 167(*l*) states that in the case of any pre-1970 public utility property the taxpayer *may* use the applicable 1968 method for such property (see Pet. App. 73). The use of the word "may," the Commission indicates (Br. 20), "suggests" that Congress contemplated such utilities might seek permission to abandon flow through where this was the method they had been following in 1968. But such a position not only requires the assumption that Congress relied upon a possible grammatical construction as the sole signpost of its intent, but is, as the Commission recognizes (Br. 21, n. 10), inconsistent with other language in the section. For no such language appears in paragraph (2)(c) of the governing section post-1969 property. Thus if it has the significance the Commission urges, post-1969 property not subject to the election provided by paragraph 4(A), *i.e.*, post-1969 property which does not increase the productive or operational capacity of the pipeline or represents replacement of existing capacity, would not be eligible for normalization if flow through had previously been taken on similar property. Faced with this inconsistency, the Commission merely indicates that there is no reason to believe the two vintages of property were intended to be treated differently (*ibid.*).

provided utilities like Texas Gas with a continuing power to switch from flow through to normalization with the consent of the Commission, would result in a situation in which the election as initially proposed by the Senate would be largely redundant and the Conference's later action in restricting its scope would constitute an exercise in futility.

One would think that petitioners' attempts to show that the Senate bill "added" a separate election provision to the remedies already available to the utilities would start with the language of the Senate bill. This is particularly so in the absence of any clear statement in the Senate Report of intent to add a new remedy. But the reason for the absence of any such reference in petitioners' briefs becomes clear when the relevant text of the Senate bill, attached hereto as Appendix A, is examined.

As paragraph (4) of Section 441 of the Senate bill expressly states (Appendix A, pp. 5a-6a), the 180-day election was included "for purposes of determining whether or not a taxpayer used a flow through method of accounting for its July 1969 accounting period with respect to any property—(A) *In applying paragraph (1)(B) or (2)(C)* for taxable years beginning after December 31, 1970 . . ." (emphasis added). If the utility "so elected" within the 180-day period prescribed he was to be deemed not to have used liberalized depreciation with flow through under either of the specified provisions. In short, as the heading of paragraph 4 of the Senate bill (and of the Act as it emerged from the Conference) indicates, the election was and is part of a "special rule" governing *how* and *when* the utility's right to switch from liberalized depreciation with flow through to straight line

or normalization with respect to both old and new property was to be exercised, rather than any additional form of relief.

Moreover, as Texas Gas recognizes (Br., p. 23), the argument that the Senate election added a separate avenue of relief for utilities wishing to switch from flow through to normalized accounting and rate treatment, which was independent of their allegedly continuing right to accomplish the same result under the "third general rule," necessarily implies that the Senate superimposed upon a continuing right of the utility to switch from flow through to normalization, at any time the Commission permits, a special right to do the same thing during a limited period, which could also be implemented only with the permission of the Commission. Texas Gas would avoid this redundancy by pointing to the fact that the Senate's election also gave utilities a right, during the 180-day period, to switch from flow through to straight line depreciation. This option, unlike the one where the proposed shift was to normalization, could be availed of during the election period whether or not the Commission approved, whereas under the "general rule" Commission approval was allegedly required to switch from flow through to straight line as well as to normalization. Any such difference between the general rule and the election with respect to a move to straight line depreciation would, of course, not explain why the Congress would have "added" a provision authorizing a switch to normalization which was more restrictive than the one assertedly being supplemented. On the contrary it would suggest that the election was only available with respect to a move to straight line depreciation. But the Senate Report on the bill (S. Rep. No. 91-552, 91st Cong., 1st Sess. pp. 173-174) expressly stated that the election it was

providing applied to shift to both straight line and normalization. Moreover, any other construction would be contrary to the Commission's conclusion in Order 404, which was affirmed by the court below in the same opinion here under review,[7] that the election was applicable to a shift to normalization, if the Commission approved the move.

Texas Gas attempts to surmount these difficulties by suggesting (Br. p. 25) that Congress provided an "additional" election which gave the utility power to switch from flow through to straight line, with or without the permission of the Commission, and to normalization if, but only if, it secured such permission, as part of a conscious design "to put pressure upon the regulatory agencies when confronted with the problem during that [180 day] period more freely to grant to such a company permission to change to normalization." This may be an accurate reflection of how the tax law changes were utilized by Texas Gas. But it not only requires crediting the Congress with a degree of disingenuity for which there is no support in the legislative history of the Tax Reform Act, but requires an assumption that the drafters of the Act, who were worried about possible losses of revenue, deliberately "put pressure" upon the regulatory agencies to move from flow through in the manner which would result in the least additional tax revenues. If this in fact had been Congress' intent it could, of course, have made

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[7]This portion of the lower court's opinion involved an appeal by Memphis and the Tennessee Valley Municipal Gas Association (Case Nos. 24,518 and 24,602 in the court below) in which New York did not participate. A petition for certiorari by Memphis from this part of the lower court's opinion was denied by this court on October 16, 1972. *Memphis Light, Gas and Water Division v. Federal Power Commission, et al.*, No. 72-96.

the election available only to a shift from flow through to normalization, or at least have given the utility the unlimited option to do so, just as it did with respect to shifts to straight line.

Finally the position of both the Commission and Texas Gas leaves the action of the Conference in deliberately restricting the election to new expansion property devoid of all meaning. Of course if the election, as originally drafted by the Senate, applied only to a shift from flow through to straight line depreciation, its subsequent restriction would not affect any continuing rights of the Commission to authorize a move from flow through to normalization. But this is one construction of the Act which no one has attempted to advance; as we have seen *supra* at p. 19, it is clearly precluded by the language of the Senate amendment which refers back generally to paragraphs (1)(B) and (2)(C) of the section. Accordingly what both the Commission and Texas Gas are necessarily contending is that the conferees' deliberate restriction of the election to new, expansion property was of no effect with respect to a shift to normalization since the alleged "general" right of a utility to make the same shift survived the limitation to new expansion property of the 180-day election to do the same thing. It goes without saying that such a construction of congressional action is not favored.

B. The Lower Court's Construction of the Tax Reform Act's Amendment of Section 167 of the Internal Revenue Code Is Consistent With Congressional Intent

The "problem" which led to the amendment of Section 167 of the Internal Revenue Code in the Tax Reform Act of 1969 is well summarized at pp. 131-132 of the House Report on the bill. (H. Rep. No. 91-413, 91st Cong., 1st Sess.) See also S. Rep. No. 91-552, 91st Cong., 1st Sess., pp. 175-176; General Explanation of the Tax Reform Act of 1969, prepared by the Joint Committee on Internal Revenue Taxation, pp. 150-151 (set out in the brief in this case filed by Memphis).

Congress had already reduced federal revenues by making available to gas pipelines and other regulated utilities the option to use various methods of liberalized depreciation in calculating their federal income tax, an action which, where the company enjoys an expanding or stable plant, results in a permanent tax savings. The revenue loss had been enhanced as more and more state and local regulatory bodies, in recognition of the tax savings effect of the use of liberalized depreciation, concluded that there was no basis for permitting the companies to include a fictitious tax expense in their cost-of-service calculations by "normalizing" the amount charged to federal income taxes, *i.e.*, by claiming as an expense the higher amount they would have owed had they instead taken straight line depreciation. Consequently, these regulatory bodies (which included the Public Service Commission for the State of New York as well as, eventually, the Federal Power Commission) limited the regulated company's tax allowance to its actual tax liability, and thus flowed through the tax savings to

consumers. Since the inability to inflate their rates by the non-existent tax expense *pro tanto* reduced the regulated companies' net income, the treasury "lost" the additional tax revenues they would have received from taxing such additional income.[8] As the House Report notes as of 1969 about half the regulatory agencies required utilities subject to their authority to flow through the resulting reduction in federal taxes to their customers.

While Congress was interested in preventing any more regulatory agencies from requiring regulated companies voluntarily utilizing liberalized depreciation to flow through the benefits to their customers, by far the most serious threat to treasury revenues was the possibility that additional regulatory bodies would follow the lead of the California Public Service Commission and *impute* the use of liberalized depreciation with flow through to companies, like the Bell System, which up to that time had always utilized straight line depreciation.[9] It was reported to the House and Senate Committees that if this decision (which was then on appeal) was affirmed, and particularly if the Federal Communications Commission was to go through with its announced plan of considering adoption of a similar policy for all of the Bell System's

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[8]The Congressional reports talk in terms of the loss to the treasury in tax revenues from utility use of liberalized depreciation being doubled where the utilities rather than their customers secure the benefit of the tax reduction. See, *e.g.*, House Rep. p. 134. This is, of course, only true if one focuses upon the reduction in utility income and ignores the resulting increase in business customer income which is also subject to federal tax.

[9]*Pacific Telephone and Telegraph Co.*, 62 Cal. P.U.C. 53, *affirmed, City and County of San Francisco v. Public Utilities Commission*, 490 P.2d 798 (1971).

interestate rates,[10] the huge Bell System would of necessity be required to switch to the use of liberalized depreciation. See, *e.g.*, Hearings before the House Committee on Ways and Means, 91st Cong., 1st Sess., on the Subject of Tax Reform, pp. 38, 58-98. And to these immense tax revenue losses might have been added those from other utilities than using straight line depreciation but faced with the threat that their regulatory agency would impute to them the use of liberalized depreciation on grounds it was their duty to minimize costs.[11]

The Federal Power Commission's preferred response to this problem was to withdraw from the pipelines and other utilities the right to use other than straight line depreciation, see House Report, p. 132. This remedy, which would have been most favorable from the standpoint of the treasury, was, however, rejected by the Congress on grounds that:

> "In too many cases this would place regulated utilities at an unfair competitive advantage, both in terms of the sales of their products or services and their attractiveness to equity investors. Also this

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[10] See *American Telephone and Telegraph Co. and the Associated Bell System Companies, Charges for Interstate and Foreign Communications Service*, 9 FCC 2d 30, 84.

[11] The Federal Power Commission had never imputed the use of liberalized depreciation to a company which had consistently used straight line. But in *Midwestern Gas Transmission Co.*, 36 FPC 61 (1966), *affirmed, Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444 (C.A. 7), *certiorari denied*, 392 U.S. 928, the Commission had imputed the use of liberalized depreciation to a pipeline which had attempted to shift to straight line depreciation after the Commission held liberalized depreciation would be flown through.

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would result in prompt, substantial, and widespread utility rate increases.[12]

"Accordingly your Committee has determined *in general to 'freeze' the current situation regarding methods of depreciation* in the case of those companies in what are, by and large, the more healthy utility industries. No change is made regarding utility industries whose members are, by and large, earning well below their permitted rates of return." (House Report, No. 91-413, *supra*, p. 132-133, see also Senate Rep. No. 91-552, *supra*, p. 172.

The principal threats to the treasury were taken care of by the Congress by absolute prohibitions upon any regulated company not already on liberalized depreciation with flow through moving thereto, and upon any regulatory imputation of liberalized depreciation with

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[12] The Texas Gas brief (pp. 61-62) notes that this language about rate increases, and similar language in the Summary of the Bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation and the Committee on Finance at p. 73, does not appear in the Senate or Conference Reports. It suggests that this indicates that later versions of the bill were recognized as providing for greater and more immediate rate increases.

In view of the fact that the Senate Report repeats, almost verbatim, the "freeze" language from the House Report, it would appear that the absence therein of a reference to limitation of rate increases may well represent its efforts to paraphrase in one paragraph the first four paragraphs in the House Report as to "general reasons for change." But if one is to join Texas Gas in its excursion into psychohistory, it can be as easily postulated that the language was left out of the Senate Report because its *substitute* of a 180-day election period, and the new election's absolute right for a utility to shift to straight line depreciation, led it to believe that the rate increases permitted (*prior* to scaling down the election in conference) would result in more immediate and more substantial rate increases.

flow through to companies choosing to remain on straight line depreciation. (This latter objective was achieved by prohibiting a company, not already on liberalized depreciation with flow through, from utilizing any of the liberalized methods of depreciation unless the regulatory agency prescribed normalization.) And finally any shift from straight line depreciation to liberalized depreciation on pre-1970 property was prohibited.

All of these provisions to preclude moves to flow through were in the House version, and the Senate and Conference modifications did not affect them. The issue is instead the extent to which the Senate's adoption of the 180-day election period for moves *to* straight line and normalization, and the Conference Committee's subsequent reduction of its scope, limited the range of the rate increasing shifts from the *status quo* which the House bill had permitted.

In this context the court of appeals' construction of the bill's developments in the Senate and Conference as precluding shifts from flow through except for new expansion property are, we submit, far more in keeping with the Congress' continuing determination "in general to 'freeze' the current situation regarding methods of depreciation" (House Report, p. 133, Senate Report, p. 172) than the construction, necessarily adopted by the Commission and Texas Gas. For they are required to argue that the Senate, through professing to adhere to the "freeze," provided an "additional" way for utilities to raise their rates, and that the conference's later limitation of this election, left unimpaired the avenue originally provided by the House bill.

The Commission brief (p. 38) recognizes that one of the major purposes of the "freeze" was "to guard against

'prompt, substantial and widespread' rate increases." It says, however, that this was to be accomplished by limiting the changes in "methods of depreciation" which would cause such increases to those "particular situations [where] the abandonment of flow through by a utility would be in the public interest." (See FPC Br. p. 29.) This statement is of course completely inconsistent with the Commission's position in Opinion No. 568 that it was Texas Gas' exercise of the election to shift to normalization for its new property which required it to approve the proposed switch to normalization on Texas Gas' old property as well. (See Part II of this brief.) Moreover, it certainly does not detract from the validity of the lower court's conclusion (Pet. App., pp. 46-47) that the Senate bill increased the likelihood of substantial immediate rate increases by requiring all shifts to be made within 180 days and making possible shifts to straight line depreciation without any agency approval, and that the conference compromise was to limit all such changes to new expansion property. For this interpretation, unlike the construction propounded by the Commission and Texas Gas, would allow for a gradual shift to straight line or normalization with respect to new expansion facilities—[13] and to this extent increase tax revenues[13]—without

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[13] It is this gradual shift, with respect to new property, rather than any precipitate changeover on existing property, which, we suggest, was contemplated by the Congress when it estimated that tax revenues would increase by 60 million in 1970, 260 million in 1974 and 310 million in 1979. (House Report, p. 134.) And the Senate Report's statement (p. 176) that these sums did not take into account the uncertain effect of the election (then not restricted to new expansion property) could well reflect its recognition that forcing a choice within 180 days (plus freeing shifts to straight line from any agency restraint) would affect the timing and extent of such rate increases.

adding immediately to the inflationary pressures, of which the Congress was all too well aware, by the immediate and substantial rate increases which would result from affirmance of the Commission's action here.

II.

THE COMMISSION'S ACTION PERMITTING TEXAS GAS TO CHARGE ITS CUSTOMERS FOR TAXES IT HAD NOT PAID WAS INVALID, EVEN IF IT WAS NOT PRECLUDED BY THE TAX REFORM ACT OF 1969.

Since the Court below held that Congress in the Tax Reform Act of 1969, had prohibited any pipeline taking liberalized depreciation with flow through from shifting to normalization except for new expansion property, it did not reach the several other contentions of the Memphis and New York as to why the Commission's action in Opinion 578 was invalid. Like petitioners we do not believe that a remand to the Court of Appeals is necessary to resolve these issues. But, even assuming the Commission retained the authority in appropriate circumstances to permit a pipeline to include an allowance for federal income taxes in its cost-of-service based on the taxes it would have paid if it had taken straight line depreciation, when in fact it paid substantially less due to its utilization of liberalized depreciation, it is clear that the Commission's decision to permit the Texas Gas rate increase was invalid.

1. The Commission brief starts from the assumption that the Commission has almost unlimited discretion in how it fixes rates and, in particular, in how it treats various tax savings in fixing such rates. But the

"end result" shiboleth of the 1943 Hope case,[14] is not the limit of judicial expression as to the proper manner in which an agency can fix rates. With special application to charges for federal taxes it has been repeatedly held that a regulated company is, in addition to a return of its operating expenses and a return on its prudently invested rate base, entitled to recover in rates enough to pay its federal and state taxes. See, *e.g., City of Chicago v. Federal Power Commission*, 385 F.2d 629, 633 (C.A.D.C.), *certiorari denied, sub nom. Public Service Commission of Wisconsin v. Federal Power Commission*, 390 U.S. 945. But as this Court expressly held in *Federal Power Commission v. United Gas Pipe Line Co.*, 386 U.S. 237, 244:

> "... when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the rate making principle that limits cost of service to expenses actually incurred. Nothing in Colorado Interstate[15] or Panhandle[16] forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary both cases support the power *and the duty* of the Commission to limit cost of service to real expenses. (Footnote omitted, emphasis added.)[17]

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[14] *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602.

[15] *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581.

[16] *Panhandle Eastern Pipe Line Co. v. Federal Power Commission*, 324 U.S. 821.

[17] The Court in *United* also characterized as "untenable" a United position on the allocation issue involved in that case which

In so holding this Court, as it recognized (386 U.S. at 245, n. 3), was following the earlier precept of Judge Tuttle in *El Paso Natural Gas Co. v. Federal Power Commission*, 281 F.2d 567 (C.A. 5), *certiorari denied, sub nom., California v. Federal Power Commission*, 366 U.S. 912. In *El Paso* the Court rejected the claim that the company was entitled to the benefits of the percentage depletion and intangible well drilling allowances provided to gas producers, holding (281 F.2d at 572-573) that:

> "The requirement that the Commission determine a just and reasonable rate is not modified by reading into the statute an exception to the extent that the prices charged may be sufficient to afford a just and reasonable rate *plus* an amount representing a savings in taxes granted the gas industry . . . .
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> "We think, in short, that there is no statutory authority for the Commission to treat actual savings as taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the

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"would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred" (386 U.S. at 244).

In *United* both the court majority and minority agreed that tax savings property attributable to the regulated company could not form the basis for an additional return to the company. The issue between them was whether, in the context of a consolidated tax return, a profit making regulated company could properly be allocated any of the tax savings which had reduced the effective rate of the system as a whole below the 48% norm.

natural and necessary consequence of rate regulation (emphasis in original).

See also to the same effect *City of Chicago v. Federal Power Commission, supra,* 316 F.2d at 633-634 (C.A. D.C.); *Alabama-Tennessee Natural Gas Co. v. Federal Power Commission,* 359 F.2d 318, 327-328 (C.A. 5), *certiorari denied,* 385 U.S. 847. And as the Court of Appeals made clear in the latter case (*ibid.*) this "traditional regulatory concept" goes back at least as far as this Court's opinion in *Lindheimer v. Illinois Bell Telephone Company,* 292 U.S. 151, 169.

2. While the administrative and judicial history of liberalized depreciation is a checkered one, it does not upon any proper analysis yield to the "anything goes" interpretation advanced by the Commission. On the contrary when the courts have approved deviation from the actual taxes precept it has been either because they were convinced that a factual question was presented for agency expertise as to whether the tax reduction was more likely to be a temporary deferral than a tax savings, or because they felt that Congress had mandated that the tax savings go to the utility's stockholders rather than its rate payers.

The Federal Power Commission's grappling with the problem of how to treat liberalized depreciation got off on the wrong foot in *Amere Gas Utilities Co.,* 15 FPC 760. The Commission had previously ruled that the special provisions of Section 168 of the Internal Revenue Code, authorizing the rapid tax amortization of emergency facilities built to aid the Korean War involved a tax deferral rather than any permanent tax savings and had therefore authorized normalization of the taxes paid. *Treatment of Federal Income Taxes as Affected by*

Accelerated Amortization, 12 FPC 369. It applied the same policy in *Amere* to the provisions authorizing utilities to use liberalized depreciation for tax purposes which Congress added as a permanent feature of the tax law by the adoption of Section 167 of the Code in 1954. Though the Examiner in *Amere* had found that, when the company's operations were considered as a whole, the use of liberalized depreciation produced tax savings rather than a mere tax deferral (15 FPC at 773), he concluded that the Congress had intended that the benefits of the tax reduction go to the owners of the business rather than the shareholders. The Commission, in affirming his decision, in addition concluded that the use of liberalized depreciation would result in a tax deferral rather than tax saving. See 15 FPC at 782. The Commission continued to authorize normalization either on the basis of an assumed Congressional mandate or because, focusing upon the individual units of plant, it construed liberalized depreciation as providing only for a temporary tax deferral, until 1964. See, *e.g.*, *El Paso Natural Gas Co.*, 22 FPC 260, 266-67; *United Fuel Gas Co.*, 23 FPC 127, 512; *Northern Natural Gas Co.*, 25 FPC 431.

In *El Paso Natural Gas Co. v. Federal Power Commission*, *supra*, the Court of Appeals, despite Judge Tuttle's ringing reaffirmation of the actual taxes doctrine as related to the Commission's attempt to give the company the benefit of the depletion allowance and intangible well drilling tax savings, refused to intervene to upset the Commission's approval of the company's normalization of liberalized depreciation. It did so on the grounds of its belief that "in practical effect this [the use of liberalized depreciation] works a tax deferral rather than a tax savings" and that normalization was therefore appropriate to "equalize [higher] tax payments in later years."

281 F.2d 567 at 573-574. Similarly, the Court of Appeals for the Fourth Circuit in *Cities of Lexington, etc. v. Federal Power Commission*, 295 F.2d 109, 111-115, affirmed the Commission's normalized treatment of liberalized depreciation in the *United Fuel Gas* case, *supra*. Though it recognized that there was a dispute as to whether a tax savings or tax deferral was involved, it believed that the resolution of this factual question involved a "problem in a special field which requires the exercise of expert skill that has generally been entrusted by state and federal legislation to administrative regulatory tribunal whose decisions, in the absence of an abuse of discretion, should be followed by the courts" (*id.* at 114). But at other parts of its opinion (195 F.2d at 115-117) it expressed its agreement with Judge Tuttle's conclusion in *El Paso, supra*, that actual tax savings could not be ignored in fixing a regulated company's cost of service stating (195 F.2d at 116):

> "We find nothing in the Natural Gas Act which requires the Commission to ignore the usual principles of cost accounting and set up a fictitious and unreal tax expense on the part of the utility in order to give it the entire benefit of the tax saving statutes and none to the consuming public. The very spirit and purpose of the regulatory provisions of the Natural Gas Act point the other way. *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 610, 612, 64 S.Ct. 281.

See also *Panhandle Eastern Pipeline Co. v. Federal Power Commission*, 316 F.2d 659 (C.A.D.C.), where the Court in affirming the Commission's limitation of the return on the increasing reserve fund established by the use of liberalized depreciation to 1.5%, apparently assumed (316 F.2d at 661, 663 n. 1) that liberalized depreciation involved "tax deferrals rather than tax savings." But the

Court also held that "nothing in the language or legislative history [of Section 167 of the Internal Revenue Code] indicates that Congress considered its regulatory consequences" (316 F.2d at 662).

This was the situation when the Commission in 1962, in the light of the decisions in *El Paso* and *Panhandle*, *supra*, indicating that its hands had not in fact been tied by the Congress in adopting Section 167 of the Internal Revenue Code, initiated a thorough reexamination of the problem. Its conclusion in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, *affirmed*, *Alabama-Tennessee Natural Gas Company v. Federal Power Commission*, 359 F.2d 318 (C.A. 5), *certiorari denied*, 385 U.S. 847, was that Congress in adopting Section 167 had not modified the general rate making objectives of the Natural Gas Act to provide service to gas consumers at "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest" (see *Atlantic Refining Company v. Public Service Commission*, 360 U.S. 378, 388). And it found that "the use of liberalized depreciation results in a permanent reduction of federal income taxes by natural gas pipelines maintaining either a growing or stable plant" (31 FPC at 221). Since Alabama-Tennessee was found to be a growing company, the Commission ordered it to flow through the tax savings from its use of liberalized depreciation to its customers. And it maintained this position with respect to all other pipelines taking liberalized depreciation until the present case.

3. It is in this context that we must consider the validity of the rationale adopted by the Commission in the present case for permitting Texas Gas to shift to flow through for its existing and non-expansion property. And

it is particularly noteworthy in this respect that the Commission opinions (App. 100-111, 145-149) do not, despite the Commission's reference in its brief (p. 31) to the present gas supply crisis, suggest that Texas Gas will not continue to maintain a growing or at least stable plant with respect to its pipeline operations.[18] On the contrary, it concluded (App. 110) that "while Texas Gas' pre-1970 properties may represent a declining net investment, the company will undoubtedly be adding to its entire rate base by post-1969 construction. . . ."[19]

The principal thrust of the Commission's opinion is not that Texas Gas as an ongoing entity will cease to reap tax savings from its continued use of liberalized depreciation on all of its property, but that, because it had been permitted to normalize its taxes with respect to new expansion property, its use of liberalized depreciation for its old and non-expansion property, considered in isolation from the new property, would no longer be likely to result in tax savings. As the Commission put it in Opinion 578 (App. 108-109):

> "It therefore follows that the pre-1970 tax plant will not be a stable plant in the sense that plant retirements are replaced by new facilities, but the

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[18] The Commission brief (p. 31) suggests that the gas shortage indicates that "the continued rapid expansion of the natural gas industry can no longer be taken for granted." But in *Alabama-Tennessee* it held that liberalized depreciation results in tax savings whenever a pipeline maintains a "growing or stable" plant, 31 FPC 208, 221. And it does not find to the contrary here.

[19] The evidence to date supports this prediction. The Annual Reports filed by Texas Gas with the Commission show that its gross gas utility plant account increased from $522,371,664 in December, 1969 to $583,090,599 on December 31, 1971. This is more than an 11% increase in just two years.

basis of tax depreciation *related thereto* will decline, so that there is little chance *with respect to this plant* that there will be any permanent tax savings" (emphasis added).

We show below that this analysis is faulty on its own terms. But what is of primary importance is the recognition of the fact that no justification is advanced—other than the Commission's mere assertion—for the underlying proposition that, because Texas Gas is now to be permitted to use normalization with respect to a portion of its pipeline facilities—its new expansion property—its continued use of liberalized depreciation on all of its property will cease to result in a tax savings. All that the use of normalization on its new expansion property will mean is that, to this extent, Texas Gas will be authorized to collect rates based on fictitious taxes and will accrue thereon an ever increasing amount which will be available for the payment of any tax increases should they ever eventuate. But Texas Gas' federal income taxes, including its depreciation deductions, will continue to be calculated on a company-wide basis. Thus if, as a company, it maintains a growing or stable plant—as the Commission assumed it would—there will be a consistent tax savings. The possibility of future higher taxes relating to old non-expansion property—if this part of the total plant does not remain stable—will continue to be offset by the lower taxes attributable to new expansion facilities. In short, all the Commission's decision comes down to is a reversion to the now discredited unit-by-unit analysis of the effect of a company's use of liberalized depreciation,

packaged in terms of the new, but equally artificial dichotomy of new versus old property.[20]

The Commission's brief confines itself to the bare statement (pp. 31-32) that "for ratemaking purposes, the benefits of liberalized depreciation on the company's expansion property are no longer available in calculating the company's tax expense on its books of account to offset the effects of declining tax depreciation on the company's books of account arising from the continued use of flow through on existing property." If this statement is intended to mean that the Commission, which elsewhere in its brief (pp. 12, 18) claims almost unlimited authority to determine the "proper" allowance to be made in a rate case for federal income taxes, in fixing the tax component of a cost of service must segregate pipeline facilities which for tax purposes the Internal Revenue Service treats as a unity, it is as amazing as it is invalid. We assume, however, that in its reply brief the Commission will fall back on the rationale used by Texas Gas below, namely that under the present language of Account 282, the new sums to be included in this account by Texas Gas, as a result of the normalization of its new expansion property, will not be available to pay any higher taxes which might be associated with old non-expansion property.

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[20] We do not have a situation presented here, as in the consolidated tax situation presented in this Court's opinion in the *United Gas Pipe Line Company* case, *supra*, where issues as to the proper allocation of tax savings among various elements of the system are required. All of the tax savings from the use of liberalized depreciation with normalization on new property will accrue to Texas Gas, and this will become an increasing amount of the total savings as new plant gradually becomes a higher percentage of total plant.

Any such argument is specious. In the first place it assumes that there will be increased taxes, despite Texas Gas' continuation to utilize depreciation on all its property and the Commission's conclusion (App. 110) that Texas Gas as a whole will maintain a growing or stable plant. Secondly, it ignores the $12,993,624 already in Texas Gas' Account 282, as of December 31, 1969, all of which is available for use in the unlikely event Texas Gas' taxes subsequently are increased as a result of its use of liberalized depreciation.[21] And finally even if the present language of Account 282 (18 CFR 201 § 282, set forth as Appendix B to this brief) can be construed as authorizing a charge to the account only with respect to property with respect to which the company previously normalized the effect of its use of liberalized depreciation—and this seems a very narrow reading of the language of the account[22]—there is nothing, except its unwillingness, to prevent the Commission from modifying the language of the account, or establishing additional accounts, to give appropriate consideration to the new situation caused by the bifurcation of depreciation treatment of pipeline property which Congress clearly

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[21] This fund was created during the period prior to 1966 when Texas Gas was permitted to normalize under the earlier erroneous views of the Commission on the matter.

[22] Paragraph B of Account 282 states that the account "shall be credited" by the amount in any year "taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years. . . ." This does not limit the prior deferral to any specified item of property. And in any event there is nothing in the language of the Account to indicate that the Commission could not or would not *permit* its utilization in other appropriate circumstances.

intended in the Tax Reform Act of 1969. Accounting is only the Commission's master if it is allowed to be.

Moreover, even if it were proper to segregate for special consideration the old non-expansion property of the pipeline, the Commission's calculations as to the long range tax effects thereof are lacking in merit. The Commission's stated reason for its view that the lower taxes on replacement or other non-expansion property would be inadequate to offset the increased taxes on old property was that the tax lives of various types of pipeline property are substantially less than their physical life. Thus it concluded that it was unlikely that replacements would be of a sufficient magnitude to offset the increased taxes due to the use of liberalized depreciation on Texas Gas' existing property in earlier years (App. 108-109). In its brief it attempts to support this conclusion with extra-record figures showing that Texas Gas' average plant retirements for the period 1965-1969, valued at cost, were only $2.7 million per year. This amount, the Commission asserts, if replaced by new facilities at the same cost[23] would be inadequate to match the annual increase in tax obligations on its old non-expansion property. The Commission, on the basis of

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[23] The Commission suggests in its brief (p. 33, n. 13) (but not its opinion) that the obviously greater cost of replacing facilities today as contrasted with their original cost should be ignored because Texas Gas has chosen to utilize an optional formula provided by the Internal Revenue Service's Regulations under which the maximum amount of investment to be classified as replacement property in any year is an amount equal to its plant retirements in that year. Assuming such calculations are appropriate for tax purposes, there is no basis for assuming that Texas Gas, by voluntarily availing itself of this tax option, can bind the Commission in its exercise of its regulatory powers.

record testimony obviously relating to a different matter (App. 17), indicates that this annual increase in tax obligations as the result of the use of liberalized depreciation on Texas Gas' existing plant amounted to approximately $33,000,000 for the year 1971 alone.[24] Since the total federal income tax obligation for Texas Gas' gas utility operations in 1970 was only $25,666,000 (*Statistics of Interstate Natural Gas Pipeline Companies 1970*, FPC 1971, p. 118), the magnitude of the probable error in this figure is clear. But aside from this error—which is perhaps inevitable in view of the fact that the hearing in the case was not concerned with any proposed move to normalization (see p. 7, *supra*)—there is no basis for assuming that the $2.7 million average is representative of the future period. On the contrary, exactly because the physical life of major plant items like pipe are long ones it is to be expected that average system retirements would have been substantially less during the first twenty to thirty years of Texas Gas' operational life than they will be in the future.

There is, moreover, an additional fallacy in the Commission's position. For if it is correct in its view that the old non-expansion property should be looked at in isolation in determining the effect of the use of liberalized depreciation then it must also be looked at by itself in determinating the total tax obligation due the federal government. But when this is done it becomes apparent that the total tax obligation with respect to this part of

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[24] Actually the $33,000,000 testified to by the Texas Gas witness appears to be the amount of new plant the pipeline would have to put into operation to compensate for the $1,100,000 *total* reduction in its plant accounts due to the taking of depreciation on such plant at an annual effective rate of 3%.

Texas Gas plant will continue to decline (see Exhibit 21, App. 42). This fact is recognized by the Commission in its Opinion, but brushed aside with the statement that "in our opinion, the effect of the declining rate base should not be used to offset the effects of liberalized depreciation with flow-through. Where there is no new investment the rate base declines in any case regardless of the method of tax depreciation" (App. 110).

Of course, the point is that if the overall tax obligation goes down faster than any one component thereof arguably increases, the danger that the pipeline's future customers will have to pay higher rates to make the company whole for federal higher tax obligations disappears. Assuming that present rate payers might properly be charged higher rates now to offset necessary or probable increased rates in the future, it does not follow that they can or should be charged higher rates now in the hopes that at some future date lower tax charges might therefore be even further reduced. In this respect it is important to note that the immediate payment of lower taxes as a result of the use of liberalized depreciation does not carry with it any obligation to pay higher taxes in the future. What the amount and rate of such future tax obligation will be depends upon the law as of that date and the profitability of the pipeline. If the worst fears of the pessimists as to pipeline prospects in future decades materialize—and there is no reason to believe they will[25]—then the present use of liberalized depreciation will not require any tax payment out of line with any possible reduction in net pipeline income.

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[25] See footnote 19, *supra*.

4. While both the Commission's opinion and its brief mention several other alleged benefits of its action permitting Texas Gas to move to normalization with respect to its old, non-expansion property, we do not read either as asserting that these factors would independently justify a switch to normalization if, contrary to its basic conclusion, the use of liberalized depreciation continued to constitute a tax savings. See App. 109. In any event, any such conclusion would clearly be improper.

The three denominated extra benefits of the Commission's action are an alleged greater stability in rates, the improvement of the companies before tax coverage of interest and the alleviation of present day cash shortages. The first of these is directly tied into the Commission's artificial bifurcation of Texas Gas' plant. Obviously an immediate $4,400,000 increase in Texas Gas' rates only breeds rate stability if it is assumed that the alternative is a higher increase at a later date, an assumption which in turn depends both on the tax deferral concept and the asserted irrelevancy of the declining rate base discussed above.

The other two "benefits" are from the viewpoint of the company's stockholders more concrete. If it is proper for the Commission to charge Texas Gas' ratepayers $4,400,000, over and beyond its actual cost of service including a fair return on its invested capital, so that the company will have the benefit of approximately half of this sum,[26] then of course the company will be better off than it otherwise would have been, even if it is not permitted to transfer the value of these additional sums

[26] The other half will be taxed as pipeline income. See text at 44-45.

to retained earnings or to pay them out by way of dividends. But unless we are talking in the context of a demonstrable tax deferral, what is involved is merely a forced consumer contribution to pipeline capital which, for purely cosmetic reasons, is being labeled as tax related.

As we have previously pointed out (pp. 30-32) the courts, in the *United, El Paso* and *Alabama-Tennessee* cases, *supra*, among others, have repeatedly stated that the Natural Gas Act's regulatory goals do not contemplate that rates will be set "to afford a just and reasonable rate plus an amount representing a savings in taxes granted the gas industry."[27] The fact that the extra sum may not itself be immediately available for transfer to retained earnings or for payment of dividends[28] does not change the basic situation. Nor should it be assumed that because the Commission now[29] follows the practice of deducting the amounts placed into the special reserve account 282 from the pipeline's rate base, the operation is without cost to the rate payer. On the contrary, of the $4,400,000 per year extra he is here being asked to contribute to Texas Gas, approximately half goes to the federal government by way of taxes (since the Internal Revenue Service looks on the extra revenues as pipeline

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[27] *El Paso Natural Gas Co. v. Federal Power Commission, supra,* 281 F.2d at 572.

[28] The Commission has in at least one recent case permitted dispersion of the account without any benefit to the rate payers, *Tennessee Gas Transmission Co.*, 44 FPC 70, 729. Even if the reserve account is maintained, its presence may make it easier for the pipeline to pay out larger amounts of its unrestricted surplus in dividends.

[29] The Commission during previous periods in which it permitted normalization, allowed pipelines to earn a return on the reserve fund. See *Northern National Gas Co., supra.*

income) and the consumer "savings" from the remainder as a result of its deduction from rate base would, at an 8% rate of return, amount to only about $350,000. In short, it costs consumers about $4,150,000 per year to give Texas Gas an interest-free loan of approximately $2,200,000.

Moreover, assuming there might be circumstances in which it would be appropriate for the Commission to fix a pipeline's rates on a basis which, in addition to the other cost-of-service components, would require its consumers to contribute additional sums to a restricted reserve to be deducted from the pipeline's rate base, the present case is not even arguably a proper occasion for initiating such action. If there were demonstrable grounds for requiring gas consumers to contribute capital for pipeline expansion, the pipeline's needs in this respect would hardly be measured by the extent of the tax savings resulting from its use of liberalized depreciation and the Commission has not suggested that it is. More important, it is clear that any of the need for such consumer-contributed capital could only be evaluated as part of the determination of the pipeline's overall cost-of-service and particularly its appropriate return.

This, however, is exactly what the Commission refused to do with respect to Texas Gas. In recognition of the close relationship between the two issues, the tax treatment to be afforded Texas Gas and the appropriate rate of return it should be allowed had been set down by the Examiner for separate initial consideration as Part I of the rate proceeding (App. 81-82). A hearing on the two issues was completed and the record therein certified to the Commission for decision pursuant to its Order of December 23, 1969 (App. 82). But the Commission took

no action to decide the rate of return issue on its merits. Instead, on June 3, 1970 it issued its Opinion 578 which, pursuant to the request of Texas Gas for "Expedited Decision on Limited Issue" (App. 90-94), concerned only the tax issue.

Shortly thereafter Texas Gas filed a settlement agreement, to which New York was not a party, which proposed a settlement of all of the other issues in the proceeding including rate of return (App. 112). New York objected to approval of the settlement in view of the interrelationship between the tax issue just resolved in Opinion 578 and the 8% rate of return which underlay the settlement cost-of-service, pointing out that the Commission had indicated that its tax decision would, *inter alia*, serve to improve Texas Gas' before tax coverage of interest and cash flow position (App. 123-125). New York also raised this interrelationship between the two issues in its petition for rehearing of Opinion 578 (App. 126-127). But the Commission brushed aside the contention in its order approving the settlement on grounds that any extra amounts included in Texas Gas' cost-of-service due to the use of normalization "do not represent additional return to Texas Gas" (App. 143), and repeated this litany in denying rehearing of Opinion 578 (App. 147).

This, of course, merely ducks the issue which New York was raising. For, whether or not the extra allowance is properly classifiable as "additional return" or, as New York actually characterized it (App. 124), as additional income which "bears many of the attributes of return," any justification of tax normalization on grounds of improvement in the pipelines before tax coverage of interest or its cash flow situation cannot be evaluated

separately from the consideration of the pipeline's proper rate of return. However, as a result of the peculiar procedures followed by the Commission here, no effort was made by the Commission to consider the obvious interrelationship of the two issues. Instead the tax issue was decided first, before any consideration had been given by the Commission to Texas Gas' appropriate rate of return and without any consideration of Texas Gas' actual needs for cash or greater interest coverage. Under these circumstances the Commission simply had no basis for any conclusion that any additional rate allowance was required by Texas Gas for such purposes, even assuming that such additional allowances might otherwise be proper.

Accordingly, should this Court conclude that the court of appeals' determination that Congress precluded any shift from flow through to normalization on the pre-1970 or non-expansion property of a pipeline was in error, and proceed to resolve the issues not decided below, it can only find that the Commission's stated bases for its action here were without factual and legal support and inconsistent with the regulatory objectives of the Natural Gas Act.

CONCLUSION

For the reasons set forth in Part I of this brief the decision of the court below should be affirmed. If, however, this court does not so conclude, then it should determine, for the reasons set forth in Part II, that the

Commission's action was invalid and remand the case to the court of appeals with instructions to set aside the Commission's order and remand the case for appropriate further action.

Respectfully submitted,

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APPENDIX A

SECTION 441 OF THE TAX REFORM ACT OF 1969, AS PASSED BY SENATE

SUBTITLE E—DEPRECIATION ALLOWED REGULATED INDUSTRIES; EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION

SEC. 441. PUBLIC UTILITY PROPERTY.

(a) In General.—*Section 167 (relating to depreciation) is amended by inserting after subsection (k) (added by section 521) the following new subsection:*

"*(l)* Reasonable Allowance in Case of Property of Certain Utilities.—

"*(1)* Pre-1970 Public Utility Property.—

"*(A)* In General.—*In the case of any pre-1970 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—*

"*(i) a subsection (l) method, or*

"*(ii) the applicable 1968 method for such property.*

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

"*(B)* Flow-Through Method of Accounting in Certain Cases.—*In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—*

"*(i) the taxpayer used a flow-through* [343] *method of accounting for such property for its July 1969 accounting period, or*

'(ii) the first accounting period with respect to such property was after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

'(2) Post-1969 Public Utility Property.*—In the case of any post-1969 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under—*

'(A) a subsection (l) method,

'(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

'(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

'(3) Definitions.*—For purposes of this subsection—*

[344] *'(A)* Public Utility Property.*—The term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—*

'(i) electrical energy, water, or sewage disposal services,

'(ii) gas or steam through a local distribution system,

'(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized

by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

"(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

"(B) Pre-1970 Public Utility Property.—*The term 'pre-1970 public utility property' means property which was public utility property in the* [345] *hands of any person at any time before January 1, 1970.*

"(C) Post-1969 Public Utility Property.—*The term 'post-1969 public utility property' means any public utility property which is not pre-1970 public utility property.*

"(D) Applicable 1968 Method.—*The term applicable 1968 method means, with respect to any public utility property—*

"(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969.

"(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

'(iii) if neither clause (i) nor (ii) applies, a subsection (l) method.

In the case of any action 1250 property to which subsection (j) applies, the term 'applicable 1968 [346] *method' means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.*

'(E) Applicable 1968 Method in Certain Cases.—*If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (l) method) with respect to any public utility property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.*

'(F) Subsection (l) Method.—*The term 'subsection (l) method' means any method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable* [347] *solely by reason of the application of subsection (b)(4) or (j)(1)(C).*

'(G) Normalization Method of Accounting.—*In order to use a normalization method of accounting with respect to any public utility property—*

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

"(H) Flow-Through Method of Accounting.—*The taxpayer used a 'flow-through method of accounting' with respect to any public utility property if it used the same method of depreciation to compute its allowance for depreciation under this section and to compute its tax expense for purposes* [348] *of reflecting operating results in its regulated books of account.*

"(I) July 1969 Accounting Period.—*The term 'July 1969 accounting period' means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.*

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

"(4) Special Rules as to Flow-Through Method.—*For purposes of determining whether or not a taxpayer used a flow-through method of accounting for its July 1969 accounting period with respect to any property—*

"(A) In applying paragraph (1)(B) or (2)(C) for taxable years beginning after December 31, 1970, the taxpayer shall be deemed not to have used such method if it has so elected within 180 days after the date of the enactment of this subsection in the manner prescribed by the Secretary or his delegate.

"(B) In applying paragraph (1)(B) or (2)(C), the taxpayer shall be deemed to have used such method if it adopts such flow-through method [349] *in compliance with a change authorized within 90 days after the date of the enactment of this subsection by the appropriate State regulatory commission pursuant to proceedings instituted by such commission before April 22, 1969, during which the taxpayer proposed before April 22, 1969, to make a rate reduction conditioned upon and effective immediately after authorization by such commission of the flow-through method of accounting for the taxpayer.*

"(C) In applying paragraph (1)(B), the taxpayer shall be deemed to have used such method with respect to any public utility property for which it filed a timely application for change of accounting method before August 1, 1969, if with respect to public utility property of the same (or similar) kind most recently placed in service, it used a flow-through method of accounting for its July 1969 accounting period.

"(5) Reorganizations, Assets, Acquisitions, etc.*—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to rate-making by more than one body, or by reason of other circum-*[350]*stances, the application of any provisions of this subsection to any*

public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection."

APPENDIX B

EXTRACT FROM THE FEDERAL POWER COMMISSION'S UNIFORM SYSTEM OF ACCOUNTS PRESCRIBED FOR NATURAL GAS COMPANIES, 18 CFR 201

282 Accumulated deferred income taxes–Liberalized depreciation.

A. This account shall be credited and account 410, Provision for Deferred Income Taxes, shall be debited with an amount equal to that by which taxes on income payable for the year are lower because of the use of liberalized depreciation in computing such taxes, as permitted by Section 167 of the Internal Revenue Code of 1954, as compared to the depreciation deduction otherwise appropriate and allowable for tax purposes for similar property of the same estimated useful life according to the straight line or other nonliberalized method of depreciation.

B. This account shall be debited and account 411, Income Taxes Deferred in Prior Years–Credit, shall be credited with an amount equal to that by which taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years as described in paragraph A above. Such debit to this account and credit to account 411, shall, in general, represent the effect on taxes payable for the current year of the smaller amount of depreciation permitted for tax purposes for the current year with respect to any depreciable property for which liberalized depreciation was used in prior years, as compared to the depreciation deduction otherwise appropriate and available for similar property of the same estimated useful life according to

the straight line or other nonliberalized depreciation method ordinarily used by the utility in computing depreciation for tax purposes.

C. Records with respect to entries to this account, as described above, and account balance, shall be so maintained as to show the factors of calculation and the separate amounts applicable to the plant additions of each vintage year for each class, group, or unit as to which different liberalized depreciation methods and estimated useful lives have been used. The underlying calculations to segregate and associate deferred tax amounts with the respective vintage years may be based on reasonable methods of approximation, if necessary, consistently applied.

D. The use of this account and the accounting described above are not mandatory for any utility, which in accordance with a consistent policy, elects not to follow deferred tax accounting even though liberalized depreciation is used in computing taxes on income. If, however, deferred tax accounting is initiated with respect to any property, such accounting shall not be discontinued on that property without approval of the Commision.

E. The utility is restricted in its use of this account to the purposes set forth above. It shall not transfer the balance in the account or any portion thereof to retained earnings or make any use thereof except as provided in the text of this account without prior approval of the Commission. Any remaining deferred tax reserve balance with respect to any year's plant additions or subdivisions thereof for which liberalized depreciation accounting has been followed or, upon retirement from service of such property or predominant portion thereof, or upon

expiration of the estimated useful life on which the depreciation calculations for tax purposes are based, shall be credited to account 411, Income Taxes Deferred in Prior Years–Credit, or otherwise applied as the Commission may authorize or direct.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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REPLY BRIEF FOR RESPONDENT MEMPHIS LIGHT, GAS AND WATER DIVISION

STATEMENT OF THE CASE

This case arises under the Natural Gas Act, 15 USC 717 *et seq.*, pursuant to a filing by Texas Gas Transmission Corporation (Texas Gas) a natural gas pipe line company, of an increase in rates for natural gas sold to its jurisdictional customers for resale in interstate commerce. The Memphis Light, Gas and Water

Division (Memphis), a municipally owned distributor of natural gas and a city-gate customer of Texas Gas, intervened in the proceedings in the Commission.

All issues before the Commission were settled by agreement by most of the parties, except for the issue of the proper allowance in Texas Gas' cost of service for federal income taxes. It was stipulated among the parties that the dollar effect of the income tax issue on the agreed-upon cost of service would be $4,400,000 per year to Texas Gas' jurisdictional customers.

After a trial before the Administrative Law Judge, the Commission on June 3, 1970 issued its Opinion No. 578, (R. 100-111), followed by its denial of rehearing on July 21, 1970. (R. 145-149). In Opinion No. 578, the Commission authorized Texas Gas to abandon the use of liberalized depreciation with flow-through ("flow-through") and to adopt the use of liberalized depreciation with normalization ("normalization"). Under the Commission's decision Texas Gas pays federal income taxes on the basis of a deduction for depreciation based on liberalized depreciation, but for rate making purposes its rates are based on the higher tax payments which would have resulted had Texas Gas taken a tax depreciation based on the use of straight-line depreciation.

The Commission based its decision squarely upon Section 441(a) of the Tax Reform Act of 1969 (which became § 167(*l*)(4)(A) of the I.R.C.). It held:

(1) That Texas Gas had the right, pursuant to the election provision of subsection (*l*)(4)(A), to switch from flow-through depreciation with respect to its expansion properties (i.e. post-1969 properties which in-

crease the productive or operational capacity of the taxpayers and do not represent the replacement of existing property), and the company proposed to do so (R.105-6, 108);[1]

(2) That since Texas Gas was now entitled to retain the tax savings resulting from the use of liberalized depreciation with normalization on its post-1969 expansion properties, it followed that no tax savings resulting from liberalized depreciation on any of the company's property were any longer available to offset declining depreciation deductions with respect to its non-expansion properties (i.e. existing or pre-1970 and replacement properties) (R. 108).

(3) That as a result, the depreciable plant represented by the pre-1970 properties and replacements thereto would not be stable, but declining, and in the absence of any available offsets from higher depreciation deductions on expansion properties, would in the future result in higher taxes (R. 108);

(4) That these consequences flowing from the Tax Reform Act removed the basis of the Commission's former decisions in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 and *Mid-Western Gas Transmission Co.*, 36 FPC 61, (which required regulated utilities to flow through their savings from liberalized deprecia-

[1] Memphis took issue with the action of the Commission in Order No. 404 in which it announced that it would permit regulated companies to use normalization if they exercised the election of §167 (*l*)(4)(A) and abandoned flow-through as to expansion property. Memphis felt the Commission should discourage, rather than encourage, such an abandonment. The Court of Appeals upheld the Commission's Order No. 404 and Memphis' Petition for a Writ of Certiorari was denied by this Court. *Memphis Light, Gas and Water Division* v. *Federal Power Commission*, No. 72-96.

tion) and as a practical matter required the Commission to permit Texas Gas to normalize its tax depreciation on all its properties and, therefore, to increase its jurisdictional rates by the stipulated figure of $4,400,000 per year (R. 108).

Memphis and the Public Service Commission for the State of New York petitioned the United States Court of Appeals for the District of Columbia for review. That court reversed the Commission, holding that the effect produced by the Commission's ruling was precisely the opposite of that contemplated by Congress in the enactment of the Tax Reform Act of 1969 (FPC App. to Pet. 29-39).

The Commission and Texas Gas each petitioned for certiorari, and both petitions were granted and consolidated for briefing and oral argument.

ISSUES

1. Was it the intent and purpose of Congress, in the enactment of § 441(a) of the Tax Reform Act of 1969, to create a regulatory situation such that, if a regulated utility exercised the election therein provided to it to take liberalized deprciation with normalization with respect to its post-1969 "expansion" properties, the regulatory commission would be placed under the practical necessity of permitting such utility to abandon liberalized depreciation with flow-through with respect to all of its existing and replacement properties, thereby necessitating immediate and substantial utility rate increases?

2. Does the Federal Power Commission, under the Natural Gas Act (and irrespective of the Tax Reform Act of 1969), in establishing rates for regulated utilities, have the discretion to make an allowance for fed-

eral income tax expense which is in excess of the taxes actually incurred and paid by the utility?

3. Where a regulated utility exercises the election provided in § 441(a) of the Tax Reform Act of 1969 to change to liberalized depreciation with normalization with respect to its post-1969 "expansion" properties, remaining on liberalized depreciation with flow-through for all its existing and replacement properties, is it necessary to segregate the tax savings with respect to depreciation on expansion properties so that they will not be available to offset the declining depreciation deductions on the existing and replacement properties?

SUMMARY OF ARGUMENT

The result reached by the Court of Appeals is in perfect accord with the intent and purpose of the Tax Reform Act of 1969, § 441(a), and the contrary result of the Federal Power Commission brings about the very consequences which Congress sought to avoid.

The intent and purpose of the Tax Reform Act was to "freeze" current depreciation practices of regulated utilities, so as to arrest the trend among regulatory agencies to force utilities to switch from straight-line or "normalized" tax depreciation to a "flow-through" of liberalized tax benefits to their customers, thus reducing tax revenues. Congress was careful to accomplish this limited purpose in such way as not to cause the substantial utility rate increases which would flow from a sudden switch to straight-line or normalized tax depreciation on all regulated utility properties. It accepted a Senate amendment allowing utility taxpayers an election to change to normalized (or straight-line) depreciation, but limited this election to "expansion" property, acquired after December 31, 1969,

which increases the taxpayer's productive capacity and is not replacement of existing property. Such expansion property, starting at zero, would increase only gradually over the years.

The Court of Appeals' holding permitted Texas Gas Transmission Corporation to adopt normalized depreciation as to its expansion property, but not as to its non-expansion property. This accomplished fully the stated Congressional purposes and avoided the consequences which the legislative history shows Congress desired to avoid.

In its reversal of the Federal Power Commission, the Court of Appeals used as one of its grounds the legal principle that only income taxes actually incurred and paid should be included in a utility's cost of service for rate-making purposes. This principle has repeatedly and consistently been recognized by this Court and United States courts of appeals.

The Commission's opinion, which was reversed by the Court of Appeals, has allowed Texas Gas to normalize its tax depreciation with respect to its entire depreciable plant, thereby resulting in an immediate rate increase of $4,400,000 for that item alone. It based its decision upon its interpretation of the Tax Reform Act, although the decision brought about the very consequences which Congress, as indicated in the legislative history, had tried to avoid and believed it had avoided.

The Commission's basic error was its conclusion that the exercise by Texas Gas of its election to use normalized tax depreciation as to its then non-existent post-1969 expansion properties destroyed the basis for requiring a flow-through of liberalized tax depreciation

benefits. The Commission thought that the change in procedures as to expansion property rendered the larger liberalized depreciation benefits related to new property "unavailable" to be used to offset declining depreciation deductions on older properties. This was error, for the reasons that (1) the change to normalized depreciation as to Texas Gas' expansion properties did not reduce Texas Gas' tax deductions but only increased its revenues, (2) the tax savings resulting from liberalized depreciation were required to be placed in an account the purpose of which was to offset declining deductions on older properties, and (3) the tax changes relative to new expansion properties will in any event be *de minimis* for the next several years.

Even if the Commission's analysis of the Tax Reform Act was correct, it was error to permit the change in tax depreciation practices at the time of the Commission proceedings, because the provisions of the new Act relative to expansion property did not become effective until the end of the first tax year ending after December 31, 1970.

ARGUMENT

I.

THE INTENT AND PURPOSE OF SECTION 441(a) OF THE TAX REFORM ACT OF 1969 WAS NOT TO REQUIRE THE ABANDONMENT OF THE FLOW-THROUGH OF LIBERALIZED DEPRECIATION BENEFITS WITH RESPECT TO NON-EXPANSION PROPERTY, BUT IN GENERAL TO "FREEZE" CURRENT TAX DEPRECIATION PRACTICES.

A. The Language of the Act Contemplates the Retention of Flow-Through Depreciation as to Non-Expansion Property.

The primary inquiry in the construction of a statute is to the provisions of the Act itself.[2] The Act in ques-

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[2] *United States* v. *Public Utilities Commission of California*, 345 U.S. 295, 314.

tion is an addition to § 167 of the Internal Revenue Code (26 USC § 167) which provides for reasonable allowances for depreciation in computing federal income taxes. With respect to "public utility property" as defined in the Act, the term "reasonable allowance" is defined to mean:

(1) A subsection (*l*) method, which for present purposes is a straight-line method;

(2) Liberalized depreciation with normalization (referred to in the Act as "the applicable 1968 method" with respect to pre-1970 property, and as "any method otherwise allowable under this section" with respect to post-1969 property.)

(3) The flow-through method, if the taxpayer used that method in its July, 1969 accounting period.

In Section 167(*l*)(4)(A) the taxpayer is given an election, to be exercised only within 180 days of the passage of the Act, with respect to "expansion property" of the taxpayer, i.e. post-1969 property which increases its productive or operational capacity and does not represent replacement property. If it makes the election, the flow-through method ceases to be a "reasonable allowance" for such property.

The language of the Act itself, therefore, expressly provides for the retention of the flow-through method, both as to pre-1970 and post-1969 property where that method was already in use in July, 1969. The election to abandon flow-through is expressly limited to a very minor portion of the taxpayer's post-1969 property. That portion represents only a part of the properties acquired after December 31, 1969. The expansion properties would start at zero and grow slowly each

year. In view of the gas shortage, it is to be expected that expansion properties which increase the utility's capacity can be expected to remain minor for several years at least, and the effect of the election upon the utility's taxes and gas rates will be negligible, so far as they relate to expansion properties alone.

From the face of the Act itself, it is impossible to find an intent to bring about the abandonment of flow-through depreciation with respect to the bulk of the properties of the compánies already using that method. The major change to be gleaned from the language of the statute is the prohibition of a switch, after July, 1969, from straight-line or normalization to flow-through. The only language which expressly provides for a change in depreciation method is the election provision restricted to expansion property.

B. The Purpose of the Act Was To "Freeze" the Current Depreciation Practices, So as To Arrest the Trend from Straight-Line or Normalization to Flow-Through.

The background reason for the passage of § 441(a) is clearly spelled out in the General Explanation of the Tax Reform Act of 1969 (H. R. 13270, 91st Cong. Public Law 91-172), prepared by the Staff of the Joint Committee on Internal Revenue Taxation, at pages 150-151:

> *General reasons for change.*—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these

trends would shortly lead to annual revenue losses of approximately $1.5 billion. The Congress believed that such a revenue loss from this item would be unacceptable at this time. On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area also is complicated by the fact that many utilities do not have effective monopolies while others do, many utilities are in growing industries while others are losing ground, and many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

In light of the factors outlined above, the Congress concluded that it is appropriate in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change was made by this provision of the Act regarding utility industries whose members are generally earning well below their permitted rates of return.

The Joint Committee's concept of the Act as "freezing" the current situation finds support in the separate reports of each House of Congress as the Bill passed through its committees. The House Report on the Bill states:

Accordingly, your committee has determined in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more

> healthy utility industries. (H. Rep. No. 91-413 [to accompany H. R. 13270] 91st Cong., 1st Sess., p. 132.

The Senate Report concurs:

> Accordingly, the committee agrees with the House that it is appropriate to in general 'freeze' the current situation regarding methods of depreciation . . . (Senate Rep. No. 91-552, 91st Cong., 1st Sess., p. 172).

The effect of the Bill, as explained by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, was as follows:

> The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations. (Joint Committee Summary of the Tax Reform Bill, p. 73).

The relevant legislative history is totally consistent with the language of the Act. Both make clear that the Congress had no intent to interfere with flow-through depreciation practices already in effect. The purpose was to prevent further development of the trend of changes from other methods to the flow-through method. This was to be accomplished by simply "freezing" the existing situation with respect to existing property. The only "change" intended by the Act was in fact a prohibition against change in depreciation methods, rather than a requirement of a different method.

II.

IN ENACTING THE TAX REFORM ACT OF 1969, CONGRESS INTENDED TO AVOID THE CONSEQUENCE OF IMMEDIATE SUBSTANTIAL RATE INCREASES.

The legislative history of the Tax Reform Act of 1969 makes it clear that Congress intended to accomplish its objective in such a way as to avoid immediate, substantial rate increases, and that Congress thought it had done so when the Act was passed.

When the Bill was before the House, the Chairman of the Federal Power Commission suggested that the problem be solved by putting all regulated utilities on straight-line depreciation. (H. Rep. No. 91-413, 91st Cong., 1st Sess., p. 132). This would have resulted in the maximum increase in revenues to the Treasury. But the House was unwilling to take a step which would result in substantial rate increases to consumers. The Report states:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products and their attractiveness to equity investors. *Also, this would result in prompt, substantial and widespread utility rate increases.* (Id. Italics supplied)

It was not anticipated that the Act contemplated by Congress would cause any substantial rate increases. As pointed out above, the Summary of the Bill, prepared by the Staffs of the Joint Committee, expressly advised that the bill would accomplish its objective of forestalling further revenue losses

> . . . in a way that (with very few exceptions) will require no increase in utility rates because of tax laws . . . (p. 73).

At one stage in the progress of the Bill, an amendment was proposed and included in the Senate version which would have indeed caused substantial rate increases. The Senate's original version of the election provision of Section 167(*l*)(4)(A) was as follows:

> (4) Special Rules As To Flow-Through Method. —For purposes of determining whether or not a taxpayer used a flow-through method of accounting for its July, 1969 accounting period with respect to any property.
>
> (A) In applying paragraph (1)(B) or (2)(C) for taxable years beginning after December 31, 1970, the taxpayer shall be deemed not to have used such method if it has so elected within 180 days after the enactment of this subsection in the manner prescribed by the Secretary or his delegate.

By including the reference to paragraph (1)(B), the Senate amendment would have opened the door to abolition of flow-through as to all property (i.e. pre-1970 and post-1969). But this amendment to the bill was rejected. As the Conference Report stated with respect to the final version

> . . . the 180 day election . . . is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flow-through method is available only to the extent the new property increases the productive or operational capacity of the company. (Conf. Rep. No. 91-782, 91st Cong., 1st Sess., p. 313).

Congress has, therefore, carefully considered the prospect of permitting the abolition of flow-through as to all property and has expressly rejected it.

This fact answers Texas Gas' argument (TG Br. pp. 60-61) that Congress, despite the statement of the Joint Committee that the Bill would require no increase in utility rates, actually anticipated that it would do so after the election provision was added. The fact is that the election provision was deliberately trimmed down to apply only to a class of property which would be non-existent when the Act first became effective and would build up slowly over a period of years. The only conceivable reason for this trimming down was to avoid prompt, substantial, widespread rate increases.

III.

THE HOLDING OF THE COURT OF APPEALS ACCOMPLISHES THE CONGRESSIONAL INTENT.

The holding of the Court of Appeals is that the Commission allowance of the abolition of flow-through as to all of Texas Gas' property, with a consequent immediate increase in rates, is not consistent with the intent and purpose of the Tax Reform Act.[3] It held that the Commission may not make an allowance in Texas Gas' rates for anything other than taxes actually paid, except in the case of expansion property.

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[3] The Commission since Opinion No. 578 was issued has been deluged by rate increase filings in which substantial portions of the rate increase are based on the reversion from flow-through to normalization. To cite a few: Consolidated Gas Supply Corporation, Docket No. RP69-19, in which the annual impact is $6 million; Tennessee Gas Pipe Line Company, Docket No. RP71-6, in which the annual impact is $13 million.

This accords perfectly with the announced Congressional policy of avoiding prompt, substantial rate increases as a result of the Act, and it is completely consistent with the concept of the Act as a "freeze" of current depreciation practices.

IV.

THE RATIONALE OF THE COURT OF APPEALS ACCORDS WITH PRECEDENTS RELATED TO ALLOWANCE OF TAXES IN COST OF SERVICE.

The aspect of the holding of the Court of Appeals which is most strongly attacked by the Commission and Texas Gas is the court's conclusion that the Tax Reform Act affirmatively limits the Commission's discretion to permit abandonment of flow-through in favor of normalization. This holding is ably discussed by the court below and is persuasively defended in the brief of the New York Public Service Commission.

There is, however, another aspect of the Court's holding to which neither petitioner has addressed itself. The Court's result does not require as a foundation a conclusion that the new Act further limits the Commission's discretion as to tax allowances. The decision of the court below is amply supported by its further holding that

> There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas which has been using liberalized depreciation with flow-through with respect to their pre-1970 and post-1969 nonexpansion property to set rates which reflect actual expenditures alone with respect to such property. According to Congress the only appropriate tax

allowance for ratemaking purpose for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid. (FPC, App. A to Pet., p. 36).

The Commission, *under the Natural Gas Act,* has a duty to require the setting of rates which *reflect actual expenditures alone,* and the only appropriate tax allowance for ratemaking purposes is *the income taxes actually paid* (except for depreciation on expansion property). Therefore, the court's result must be correct, for it provides for the allowance of actual taxes, except for depreciation on expansion property.

The Petitioners' positions herein rest on the contention that, independently of the Tax Reform Act, the Commission has unfettered discretion as to whether it will allow in cost of service the taxes actually incurred and paid or a fictitious tax element based on normalization. This represents a dramatic change of position for the Commission. In its landmark Opinion in the first *Southern Louisiana Area Rate Case,* the Commission stated:

> It is an essential precept of regulatory law that no income tax allowance should be permitted except for taxes actually paid. *F.P.C.* v. *United Gas Pipe Line Co.,* 386 U.S. 287 (1967); *El Paso Natural Gas Co.* v. *FPC,* 281 F.2d 567, 573 (CA5-1960), certiorari denied *sub nom, California* v. *FPC,* 366 US 912 (1961); *Alabama-Tennessee Natural Gas Co.* v. *FPC,* 359 F.2d 318 (CA5-1966), certiorari denied 385 US 847 (1966). Where this Commission has provided an allowance for taxes which were not actually paid, it has been reversed. *El Paso Natural Gas Co.* v. *FPC, supra,* reversing 22 FPC 260, 267 (1959) (40 FPC 530, 581).

The Commission has a regulatory duty to allow only actual taxes, and it can point to nothing in the language of the Tax Reform Act which relieves it of that duty, except with respect to depreciation on expansion property.

The Commission's assumption of an unfettered discretion as to tax allowance treatment is based, in its brief herein, first, on general judicial statements as to the breadth of its discretion, and, second upon its record of affirmance on both sides of the tax normalization question. (FPC Br. pp. 16-18). A close examination of the authorities indicates, however, *that they have never departed from the principle that only actual taxes should be used in the cost of service.*

The Commission quotes *Federal Power Comm.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586, for the proposition that the Commission is not bound to "any single formula or combination of formulas," but is "free . . . to make the pragmatic adjustments which may be called for by particular circumstances." It does not at all follow that the Commission, having chosen the actual cost of service as its method for making rates, is then free to allow a cost element which is not in fact a real expense. In *FPC* v. *United Gas Pipe Line Company*, 386 U.S. 237, 244, cited by the Commission in support of its position, this Court said:

> Nothing in Colorado Interstate[4] or Panhandle[5] forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary *both cases support the power and the duty of the Commission to limit the cost of service to real expenses.* (Italics added; footnotes added)

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[4] *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581.

[5] *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635.

In that case this Court affirmed the Commission's action in requiring United Gas Pipe Line Company to flow through to its customers the tax savings realized by it as a result of its election to file a consolidated return with its affiliated companies.

The first of a series of cases dealing with proper income tax allowances in the cost of service of natural gas companies is *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (CA 5, 1960), cert. denied, 366 U.S. 912, 6 L. Ed.2d 236, 81 S.Ct. 1083. That case involved principally the treatment of special tax savings from depletion and intangible drilling expenses, realized by the pipeline company from its production activities. The Fifth Circuit in that case held, reversing the Commission, that only federal income taxes that had actually been paid for the test year were to be treated, for rate purposes, as part of the cost of service. This was clearly regarded by the Fifth Circuit as a matter of law. The court said:

> We think, in short, that there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.[6]

[6] The Court reached the opposite result on the question of normalizing the company's liberalized depreciation tax savings. However, it did so under the then current impression that the savings were only a deferral and that they represented an actual expense in the long run.

In *Alabama-Tennessee Natural Gas Co.* v. *FPC*, 359 F.2d 318 (CA 5, 1966), cert. denied 385 U.S. 847, the court, affirming the Commission's requirement that tax depreciation benefits be flowed through, discussed the regulatory concepts which underlie the requirement that only actual taxes be allowed in cost of service. The court said:

> Under traditional regulatory concepts, utility company shareholders (investors), not the consumer, furnish the capital necessary for the operation of the business. *Railroad Commission of Louisiana* v. *Cumberland Telegraph and Telephone Company*, 1909, 212 U.S. 414, 424, 29 S.Ct. 357, 53 L.Ed. 577; *Lindheimer* v. *Illinois Bell Telephone Company*, 1934, 292 U.S. 151, 169, 54 S.Ct. 658, 78 L.Ed. 1182. The consumer pays a fair return on the utility's capital and in addition pays the costs of operation including taxes, but:
>
> '. . . [I]f the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers . . . are required to provide, in effect, capital contributions . . . to secure additional plant and equipment upon which the utility expects a return.' *Lindheimer*, 292 U.S. at 169, 54 S.Ct. at 665.

Where the plant of the regulated utility is growing or stable, the use of normalized depreciation will provide a permanent tax savings which is in effect a forced contribution of capital by the ratepayers. This, as the Fifth Circuit held, is a violation of "traditional regulatory concepts."

The next in the same line of cases was *City of Chicago* v. *FPC*, 385 F.2d 629 (CADC 1967), which again affirmed the Commission's requirement of flow-through, pointing out (385 F.2d at 633) that

> The general rule followed by the Commission, and indeed most if not all regulatory commissions, is that the 'consumers should be charged for only the actual liability for Federal income taxes'. (Citing United Fuel Gas Co. 12 FPC 251, 265).

Midwestern Gas Transmission Co. v. *FPC,* 388 F.2d 444 (CA7 1968), is to the same effect. This opinion affirmed the action of the Commission in *imputing* liberalized depreciation with flow-through to Midwestern, when that company switched to straight-line depreciation after the *Alabama-Tennessee* decision. The court expressed itself as "in complete agreement" with *Alabama-Tennessee.*

Both the Commission brief (p. 17) and that of Texas Gas (pp. 63-64) infer from the case of *City of Lexington* v. *FPC,* 295 F.2d 109 (CA4, 1969), that the Commission has full discretion to go either way on the flow-through vs. normalization issue. This is a misconstruction of the cases. It is true that *City of Lexington* affirmed the Commission in allowing a pipe line to normalize its taxes. But this was done at a time when the Commission was laboring under the factual misapprehension that liberalized depreciation tax benefits were only a deferral, rather than a saving of taxes, and under a legal misapprehension of the construction of Section 167 of the Internal Revenue Code. In *City of Lexington,* the court pointed to the Commission's *finding of fact* "that the normalization method does not result in a tax saving but only a tax deferral" and that the Commission "was acting within its province as a trier of fact." (295 F.2d at 113). The court made it clear that this factual determination, within the Commission's area of "expert skill", was the controlling factor in the case. (295 F.2d at 114). The court's ad-

herence to the actual taxes principle was clearly expressed in the following statement:

> It is pointed out that in such cases as *Galveston Electric Co.* v. *Galveston,* 258 U.S. 388, 42 S.Ct. 351, 66 L. Ed. 678; *Georgia R. & Power Co.* v. *Railroad Commission,* 262 U.S. 625, 632, 43 S.Ct. 680, 67 L.Ed. 1144, and *South Carolina Generating Co.* v. *Federal Power Commission,* 4 Cir., 249 F.2d 755. Id. 4 Cir. 261 F.2d 915, it was recognized that Federal income taxes are a cost of doing business, *but only the amount of taxes actually paid is an expense which should be considered in calculating the rate to be charged to customers.* (Italics supplied)

The opinion is clear that the court did not consider that it was departing from that principle.

By the time of the *Alabama-Tennessee* case, it had become clear that "for ratemaking purposes Section 167 was not a congressional mandate to regulatory agencies to approve normalization" (359 F.2d at 329) as the Commission had supposed, and that "as long as the company continues the use of liberalized depreciation and continues to make at least some capital additions . . . liberalized tax depreciation will always exceed straight-line tax depreciation . . . (Id. at 336). The factual premise underlying the *City of Lexington* decision had thus been demonstrated to have been erroneous.

Therefore, the cases which have upheld normalization [7] do not imply that the Commission has discretion

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[7] In addition to the *City of Lexington* case, there was *El Paso Natural Gas Co.* v. *FPC, supra* (see Note 5) and *Panhandle Eastern Pipe Line Co.* v. *FPC,* 316 F. 2d 659 (CADC 1963).

to depart from the actual taxes principle. They merely followed the Commission's erroneous factual premise that the liberalized depreciation tax benefits were only temporary. Statements by the courts in these cases concerning the Commission's "discretion" and "expertise" will, on close scrutiny, be seen to apply to the area of the Commission's findings of fact in a technical field, and not to imply a discretion to abandon basic regulatory principles inherent in cost-of-service ratemaking.

All of the precedents are consistent in supporting the holding of the court below that the Commission has a "duty under the Natural Gas Act to require regulated utility companies such as Texas Gas . . . to set rates which reflect actual expenditures alone with respect to such [non-expansion] property," and that "the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas [as to its non-expansion property] is the income taxes actually paid."

There is no evidence in the Tax Reform Act or its legislative history of any intent to change that ratemaking principle as to non-expansion property.[8]

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[8] The Commission brief (pp. 22-23) cites comments in the House and Senate Reports on the Bill to the effect that companies on flow-through would continue on that basis "unless the appropriate regulatory agency permits a change as to that property." Such remarks did not purport to be statements of law defining the powers of the regulatory bodies, and in any event cannot add any provisions to those of the Act itself. The Commission apparently cites them to support its argument that the Act was not intended to "alter the authority of regulatory agencies . . . to permit the abandonment of flow-through." (Br. p. 22) Memphis' point is that the Federal Power Commission has no such authority, in any event, where such abandonment departs from the "actual taxes" principle.

V.

THE COMMISSION'S ALLOWANCE OF NORMALIZATION ON ALL PROPERTY CAUSES THE VERY CONSEQUENCES CONGRESS SOUGHT TO AVOID.

In its consideration of the Tax Reform Act, Congress expressly refused to require utilities to switch to straight-line depreciation, partly because the resulting increase in tax cost would result in prompt, substantial and widespread rate increases (*supra*, p. 12). The Commission's allowance of normalization has an almost identical rate effect as would straight-line depreciation. (The only difference is the deduction of the balance in the reserve from the rate base, under normalization, thus exempting the ratepayers from paying a return on their own capital contribution).[9] The consequence sought to be avoided by Congress has been incurred.[10]

Congress deliberately refused to permit utility taxpayers to elect to switch from flow-through to normalization with respect to non-expansion property. The Commission's rationale makes it incumbent on the Commission to permit normalization on all property, if the utility elected it for its expansion property. In effect, the Commission makes the § 167(*l*)(4)(A) election tantamount to the broader election proposed by the Senate and rejected by Congress.

Thus, both of the consequences which the legislative history shows Congress specifically attempted to avoid have resulted from the Commission's interpretation of the Act.

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[9] Deduction of the reserve balance from the rate base does not sompensate the ratepayers for being deprived of the use of their funds and for the time value of money.

[10] See footnote 3, *supra*.

VI.

THE COMMISSION ERRED IN CONCLUDING THAT TAX DEPRECIATION ON NEW FACILITIES IS NO LONGER AVAILABLE TO OFFSET DECLINING DEPRECIATION ON OLD FACILITIES.

The crux of the Commission's analysis of the effect of the Tax Reform Act is its erroneous conclusion that tax depreciation on normalized expansion facilities will not be available to offset declining depreciation on older facilities and that, therefore, the factual premise underlying the flow-through method no longer obtains. This is the real basis for its decision to abandon flow-through, and it is demonstrably wrong. The Commission's conclusion is expressed as follows (R. 108):

> Under the present circumstances the considerations applicable in *Alabama-Tennessee* and *Midwestern* do not obtain. By reason of Texas Gas' proposed election under the Tax Reform Act and Order No. 404, depreciation on its facilities, constructed after the beginning of 1970 which increase its capacity, will be subject to normalization rather than flow-through. Therefore tax depreciation on such new facilities will not be available to offset the declining tax depreciation deductions on the older facilities as contemplated in the *Alabama-Tennessee* and *Midwestern* cases.

This conclusion is erroneous for several reasons:

1. It postulates that Texas Gas will have *less* protection against future tax increases because it is receiving *more* revenues. Under flow-through on new expansion properties, Texas Gas under the *Alabama-Tennessee* principle, would be protected against a future increase in taxes (because of decreasing depreciation deductions on older property) by the higher deduc-

tions allowed on newly acquired property. This would occur, even though Texas Gas flowed through its liberalized tax benefits on all of its properties. With normalization in effect as to its expansion properties, Texas Gas gets precisely the same income tax benefits, but is not required to pass them on to its customers. Accordingly, Texas Gas' revenues are *increased* by the amount of the increase in rates necessary to normalize as to expansion property. This should give it *more* protection, not less, than it would have had before the change.

2. Tax depreciation on new facilities *is* in fact available to offset declining depreciation deductions on older facilities. The new facilities will become a part of Texas Gas' depreciable plant and will be subject to double declining balance depreciation. The difference in taxes between the liberalized depreciation and straight-line depreciation will go into the reserve account, Account No. 282 of the Uniform System of Accounts. The description of that account provides:

> B. This account shall be debited and Account 411, Incomes Taxes Deferred In Prior Years-Credit, shall be credited with an amount equal to that by which taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years as described in Paragraph A above. . . .

There is nothing in that account description, nor any fact cited in the Opinion of the Commission, nor in its brief in this Court, which prevents tax depreciation on new facilities from being available to offset declining depreciation on old facilities.

Texas Gas attempts to fill this gap by a highly theoretical accounting argument that the increasing taxes related to older property are an expense, which must be offset by "income", and that the liberalized depreciation savings are not technically "income." (TG Br. p. 70). But regardless of accounting terminology, the increased revenues collected to cover the normalized tax allowance are in fact *available* to the company, and when they are placed in Account No. 282, they are *available* to offset increases in taxes resulting from declining depreciation balances.

3. In any event, the practical effect of the normalization of depreciation deductions on expansion property will be *de minimis* for several years. As noted above (p. 9) the expansion property began at zero on January 1, 1970, and, in the light of the current gas shortage, acquisition of properties which "increase the productive or operational capacity of the taxpayer" will probably be at a low level for several years.[11] It is not reasonable to use a depreciation change with respect to a negligible amount of property as a basis for imposing currently upon the ratepayers a large increase in tax allowance relating to the entire utility plant of the company.

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[11] The Internal Revenue Service Regulations permit a taxpayer to compute its expansion property as the difference between the total cost of all new property acquired in the taxable year and the depreciated cost of property retired in the same year. Reg. § 1.167 (1)-4(c). That Regulation is clearly inconsistent with the Act's definition of expansion property. By defining it as all property in excess of retirements, the Regulation arbitrarily assumes that the depreciated cost of retired property equals in dollar value the original cost of all replacement property plus all other additions which do not increase capacity. This is far removed from reality.

The Commission again fell into error when it reasoned that

> Excluding new expansion facilities from consideration, the continued use of liberalized depreciation on the pre-1970 plant will not create a tax saving. (F.P.C. Pet. App. D, p. 62).

There is no necessity, under the Tax Reform Act, for "excluding new expansion facilities from consideration" in dealing with liberalized depreciation. Texas Gas will continue to file a single tax return, and its new expansion facilities will constitute a part of its depreciable plant, and its taxes, so far as depreciation effect is concerned, will be exactly what they would have been prior to the change. The company will continue to take liberalized depreciation on its entire plant. The only change is in its revenues.

The basic error in the Commission's conclusion that the new tax savings will not be "available" and that new expansion facilities must be "excluded from consideration" is its misunderstanding of the Congressional concept of normalization. The Commission defines normalization with respect to expansion properties as consisting of two steps:

(1) the charging of utility rates computed on the basis of straight-line tax depreciation on expansion property, while paying the lower actual taxes based on liberalized depreciation, and

(2) the segregation of the difference between normalized and actual taxes into a kind of escrow, to be held until the time that the tax depreciation *on the expansion property* falls below the straight-line level.

There is nothing in the Tax Reform Act which implies that Congress intended normalization to include the second step. It is clear from the legislative history that the retention of the difference in Account 282 is not required. The General Explanation of the Act by the Staff of the Joint Committee on Internal Revenue Taxation states;

> In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The Act permits such a definition of normalization and *does not require that additions be to a separate account described as a 'reserve for deferred taxes.'* (p. 152) (Italics Supplied).

Therefore, the Commission's second step—which is the one that creates the problem—is not required by the Act, nor is it germane to the Congressional purpose.

It is true that if the additional revenues obtained from normalizing as to expansion property are used to offset declining depreciation on older properties, then the change in depreciation practices may not substantially increase utility rates for several years. Only when there has accumulated a substantial amount of "expansion" property will a rate effect be felt. But this is precisely what Congress intended and expected.

Congress knew there would be *no* expansion property at the time of the passage of the Act. When it limited normalization to expansion property, it did so for the very purpose of postponing any effect on utility rates.

The Commission's analysis ignores still another element in the definitions included in the Tax Reform Act. The Act permits normalization only as to a minor part of new property acquired after December 31,

1969—non-replacement property which does not increase capacity. In the normal course of events, in light of the fact that the days of burgeoning pipe line expansion are over, most of the new property coming into depreciation base for the foreseeable future will be either replacement property or property which does not increase the productive or operating capacity of the company.[12] Though such new property does not come within the statutory definition of "expansion" property, it will enjoy the benefit of liberalized depreciation, and the tax savings represented by it will be "available" to offset declining depreciation on older properties, even under the Commission's concept. In fact it is not at all certain that such new, non-expansion properties will not generate sufficient tax savings, *by themselves* to offset the "below normal" depreciation on old properties. (This question was not before the Commission at the hearing stage, and there is no evidence whatsover in the record relating to it.)

In order for the depreciation on the new non-expansion properties to offset the below-normal depreciation on older properties, it is only necessary for the non-expansion plant to *remain stable.* As the Commission stated in *Alabama-Tennessee,*

> Even if the composite plant of a company remains stable, where the dollar value of retirements equals the cost of replacements, annual liberalized depreciation will not be lower than straight-line depreciation and the reserve established under normalization will not decline. (31 FPC at 215)[13]

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[12] Synthetic natural gas facilities and liquefied natural gas facilities and coal gasification facilities might fit in the latter category.

[13] The Commission has not retreated from this principle in its present Opinion, *infra,* p. 31.

Under the Tax Reform Act, a company's non-expansion property, by definition, remains at least stable, because it includes all replacement property, as well as additional property which does not increase capacity. Nevertheless, the Commission held that such would not in fact be the case, because "the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties." (F.P.C. Pet. App. C, p. 63) This generalization was not supported by any reference to any Internal Revenue act, regulation or authority. It is totally unsupported as a finding related to Texas Gas in particular, because the question was not in issue at the hearing, and there is no evidence whatsoever with respect to it.

In an effort to shore up this gap, Texas Gas (Br., p. 71) inserts a column of figures from its Form 2 (not in this record), showing that its depreciation base is declining much faster than its property is being retired, and that such has consistently been its experience. But those figures (not presented in evidence nor subject to cross-examination or rebuttal) prove nothing about the long-range future. Texas Gas' over-all depreciation rate has been in the range of 3%, but the bulk of its depreciable property is less than thirty years old. It is not to be expected that annual retirements will approximate annual depreciation until the end of the estimated service life of the company's original properties.

Therefore, not only is the Commission wrong as a matter of law in its concept of normalization as to expansion properties, but it is totally unsupported as a matter of fact in its conclusion that non-expansion plant will not in the long run remain stable.

VII.

THE COMMISSION ERRED IN OVERRULING ALABAMA-TENNESSEE AND MIDWESTERN

The Commission, after having started out upon the erroneous assumption that liberalized depreciation was a tax deferral, rather than a savings, and having corrected that error in *Alabama-Tennessee,* now returns full circle to its original discredited position, and explicitly overrules *Alabama-Tennessee* and *Midwestern* (R. 109-110).

The Commission does not attack the correctness of those decisions at the time they were made, but bases its reversal exclusively upon the Tax Reform Act of 1969, saying (R. 109-110):

> Furthermore, upon reexamination of the basis of our *Alabama-Tennessee* and *Midwestern* decisions in light of the Tax Reform Act of 1969, particularly its effect on post-1969 property, and the impact of the tax law and pipeline property, the findings made in those two cases are no longer applicable, and accordingly the cases are overruled to the extent they are inconsistent with this decision.

The Commission makes it clear that its reason for this step is its conclusion above discussed that the normalization of taxes related to expansion properties somehow segregates them from older properties for tax purposes. This is the only basis for the Commission's conclusion that normalization with respect to non-expansion properties "would lead to more stable tax costs in the long run." (Id. p. 63). There is no need to repeat here the deficiencies in the Commission's conclusion.

It should be noted, however, that the Commission did not, either in its Opinion or in its brief in this Court, attempt to argue that its conclusions were derived from the current gas shortage. This effort is made only by Texas Gas (Texas Gas Br., pp. 66-69), but it has no legitimate place in this case. Texas Gas never contended at the hearing that it needed normalized depreciation because of a gas shortage. There is no rational connection between the two and no evidentiary support therefor.

VIII.

UNDER NO CIRCUMSTANCES COULD ANY TAX RELATED RATE INCREASE HAVE BECOME EFFECTIVE IN 1970.

Even if it were assumed that the Commission's analysis of the new tax law was correct with respect to post-1969 expansion property, and were further assumed that the Commission's conclusion was correct with respect to long-run effect of the tax depreciation savings on existing and replacement properties, it has still failed to demonstrate the necessity for its approval of a change to normalized depreciation *at this time* and *in these dockets.* The rate increase in the principal case, Docket No. RP69-41 was filed on June 26, 1969, and was based upon a cost of service for the twelve months ending March 31, 1969, adjusted for known changes to December 31, 1969. The rates became effective in January, 1970.

During the entire test year as adjusted, and at the time the rates became effective, Texas Gas obviously had no post-1969 expansion property whatsover, and the Tax Reform Act of 1969 had no effect at all upon its then-existing system. The election did not become effective as to post-1969 property until the first taxable year beginning after December 31, 1970. Therefore, the increased costs could not, in any event, materialize

during the test period, adjusted. Nevertheless, despite the argument of its own Staff that any changes in tax depreciation policies should await a subsequent decision based upon a test year which showed the effect of the new Act, (Staff Br. to Comm., p. 68) the Commission proceeded to impose a $4,400,000 increase on Texas Gas' customers, effective in January, 1970.

CONCLUSION

The Congressional policy in enacting § 441(a) of the Tax Reform Act, as clearly expressed on the face of the Act and its legislative history, was to arrest the trend toward flow-through depreciation and its double tax loss to the Treasury, and to do so in a manner which would avoid immediate and substantial utility rate increases. The election provision with respect to new expansion property provided a means for a slow and gradual change from flow-through to normalized depreciation practice, which would not disrupt existing utility rate levels.

The judgment of the Court of Appeals accomplishes these purposes, and it correctly reversed the Federal Power Commission, whose Opinion would bring about the consequences Congress sought to avoid.

WHEREFORE, it is respectfully submitted that the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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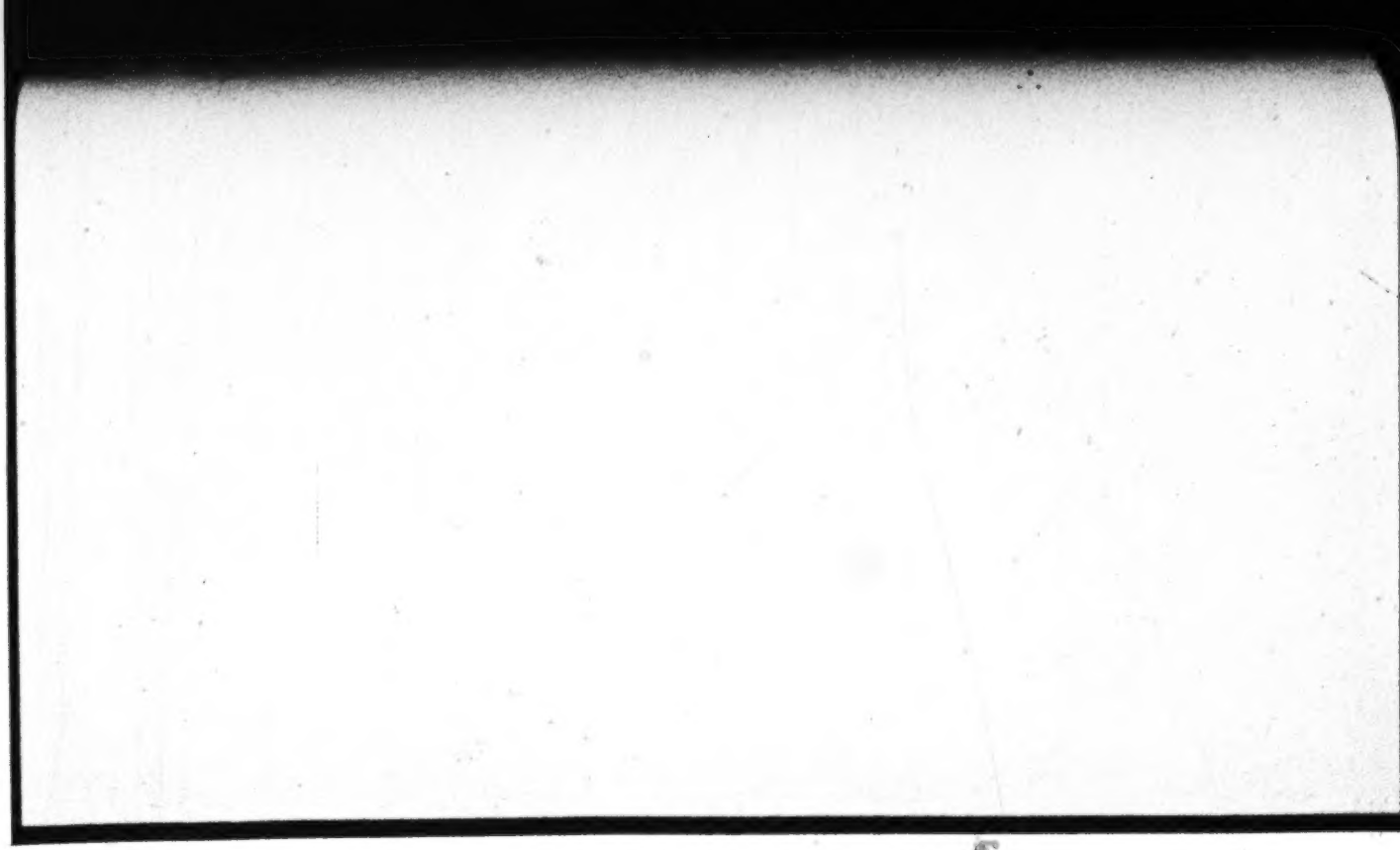

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CITATIONS

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STATUTES:

Natural Gas Act, 52 Stat. 821, *et. seq.*, as amended, 15 U.S.C. 717, *et seq.*

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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REPLY BRIEF FOR PETITIONER, TEXAS GAS TRANSMISSION CORPORATION

While our main brief anticipates and deals with most of the arguments advanced by respondents,[1] a few matters have been raised which merit a reply.

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[1] There is a question as to whether American Public Gas Association (APGA) is a respondent in the cases before this Court. APGA's only intervention and participation in proceeding in the court below related to the Commission's Order No. 404 authorizing the change to normalization for new expansion properties. The court of appeals affirmed this Commission order and this Court has denied certiorari. *Memphis Light, Gas and Water Division* v. *F.P.C.*, No. 72-96, *cert. denied*, October 16, 1972. However, since APGA presents no arguments which have not been presented by other respondents, Texas Gas takes no position on this question.

I.

THE SPECIAL ELECTION IS MEANINGFUL—NOT REDUNDANT

In their efforts to support the holding of the Court below that Section 441 withdrew authority from the Commission to permit companies on flow-through to shift to other methods of tax depreciation, respondents would perpetuate that Court's error in failing to recognize that the third general rule[2] and the right of election are separate, distinct and without overlap. For example, the New York Commission claims that (Br. pp. 18-19):

> "* * * acceptance of the contentions that the election was separate and distinct from the other provisions of the section, which allegedly provided utilities like Texas Gas with a continuing power to switch from flow through to normalization with the consent of the Commission, would result in a situation in which the election as initially proposed by the Senate would be largely redundant and the Conference's later action in restricting its scope would constitute an exercise in futility." (See also APGA Br. p. 9)

In so urging, respondents completely disregard the showing made in our main brief (at pp. 24-26) that the election is wholly separate from, and does not overlap with, the third general rule. Thus, under the right of election as proposed by the Senate Committee and restricted by the Conference Committee, a company on

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[2] It is interesting to note that nowhere in the briefs of respondents are the first and second general rules even mentioned. As discussed in our main brief (at pp. 37-53) as well as in this reply brief, the first and second general rules are important and extremely helpful in ascertaining the Congressional intent particularly with respect to the "freeze."

flow-through is assured that it could shift from that method of tax depreciation with respect to the property covered by the election during the 180 day period *irrespective of the approval of its regulatory agency.*[3] To be sure, it would have to go to straight-line depreciation if the regulatory agency does not permit it to shift to normalization,—but regardless of the tax depreciation method preferred by the regulatory agency, the company had an absolute and unrestricted right to change from flow-through with respect to that property during the 180 days of the election period.

In contrast, under the third general rule, such a company has no assurance that it would ever be able to change from flow-through as to any of its property. That rule permits a company on flow-through to change to another method of tax depreciation—whether it be straight-line depreciation or normalization—*only with agency approval.* In other words, under the third rule, which is without time limit, the company does not have any right, let alone an absolute and unrestricted right, to change from flow-through. To the contrary, it is up to its regulatory agency, from time to time, to determine whether to permit the company to change to another method of tax depreciation. And if the agency does not give its permission, the company has no choice but to remain on its then current method.

We admit that, once the election has been made with respect to new expansion property, there is no remaining discretion in the regulatory agency to permit the use of anything but straight-line depreciation or liberalized depreciation with normalization as to such property. However, the third general rule is still ap-

[3] Emphasis supplied throughout unless otherwise noted.

plicable (1) to all property other than new expansion property for a company which exercises the election and (2) to *all* property for a company which does not exercise the election.[4]

These differences between the third rule and the election, coupled with the election's 180-day limited life and the indefinite life of the third general rule, make it perfectly clear that holding the election as proposed by the Senate and revised by the Conference Committee to be an addition to, rather than a replacement for, the third general rule does not render the election "largely redundant" or "an exercise in futility".

It should be further pointed out that we agree with the New York Commission (Br. p. 18) that it should not have been necessary for us to have analyzed the pertinent language of the Senate Committee Report in the detail we did. We believe that that Report, on its face, clearly discloses the intent of the Senate Committee that the third general rule was not to be affected or impaired in any way by its proposal also to provide a right of election. This, we believe, is indicated, for example, by the facts (1) that the Senate Committee Report treats the third general rule separately from the right of election, (2) that it expressly manifests its agreement with the House Committee as to the desirability of the third rule, and (3) that it refers to the right of election as an addition to the third rule by the inclusion of parenthetical phrase "except as provided in the committee amendments which are discussed below" in its summary of the third rule (See our main brief at pp. 17-26).

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[4] Under IRS regulations the election, once exercised, is irrevocable. IRS Regs. Sec. 1.167(1)-4(i).

II.

THE HOLDING OF COURT BELOW DOES NOT ACCORD WITH CONGRESSIONAL INTENT

Respondents urge that the holding below accords with the Congressional intent in enacting Section 441, claiming the Court's holding serves (1) to permit only limited general rate increases instead of "prompt, substantial and widespread rate increases" which Congress purportedly wished to avoid and (2) to implement the "freeze" on current depreciation practices which Congress allegedly was also intent upon imposing. See Memphis Br. pp. 9-15, 23; New York Comm. Br. pp. 23-29.

In so urging, respondents disregard a number of significant factors and considerations pointed out in detail in our main brief.[5] To begin with, the report of the House Committee which refers to a so-called "freeze" and a desire to avoid "prompt, substantial and widespread rate increases" (Texas Gas Br. App. pp. 78-79) also provides for the third general rule under which, as the Court below admitted "The Commission's and Texas Gas' position here [was] clearly justified" (FPC Pet. p. 32). In other words, there is nothing inconsistent between the Commission's retaining authority to permit companies to flow-through to change to other methods of tax depreciation and the objectives of the legislation as envisioned by the House Committee.

A. Congress Did Not Expect Only "Gradual" Rate Increases

As to rate increases, it should also be noted that it is only the House Committee report which refers to

[5] Since these matters are discussed in detail in our main brief (at pp. 36-62), we will summarize them here only briefly.

rate increases. Neither the Senate Committee nor the Conference Committee report makes any mention of rate increases. They refer to neither a desire to avoid "prompt, substantial and widespread increases" nor an intent to permit only limited *gradual* increases. Respondent's present argument, which is being made for the first time, that Congress intended only limited *gradual* rate increases is created out of whole cloth without any support whatsoever.

Further, while the House Committee mentioned an intent to avoid "prompt, substantial and widespread rate increases", it was in connection with the Committee's rejection of the FPC's suggestion that *all* regulated utilities be *required* to abandon liberalized depreciation, whether with normalization or with flow-through, and to change instead to straight-line depreciation. However, the House Committee could not have indicated an intent to limit rate increases only to those resulting from the *gradual shift* to normalization by the exercise of the right of election with respect to new property, as suggested by the New York Commission (Br. p. 28, fn. 13). The right of election was first included in proposed legislation upon the recommendation of the Senate Committee; the bill as recommended by the House Committee contained no such right of election. Thus, any rate increases contemplated by the House Committee, whether gradual or otherwise, could not have been limited to those resulting from the exercise of the right of election.

Moreover, as shown in our main brief (at pp. 51-52, 56-60), the House Committee recognized that the third rule would result in some rate increases. The House Committee estimated that its proposed amendment which, of course, did not include the election, would re-

sult in revenue increases of "$60 million in 1970, $260 million in 1974 and $310 million in 1979." In addition, the Committee clearly was aware, through the colloquy between Committee Chairman Mills and FPC Chairman White (see our main brief at p. 58) that there was a "very strong likelihood" that companies which shifted to a slower method of tax depreciation with respect to "assets acquired after a certain date" would come in for rate increases once they lost the "benefit of these tax reductions." The Senate Committee estimated the same revenue increases for its amendments other than the proposed election, to which it added that it was not possible to estimate the amount of the additional revenue increases which might result from "any possible election of those on flow-through to shift, within the 180 day period, to straight-line or normalization (if permitted by their regulatory agency)". See our main brief at p. 89.

Finally, the rate increases which would result from the Commission holding here are nowhere nearly as substantial or widespread as they would have been had Congress adopted the FPC recommendation *requiring all* regulated companies to go to straight-line depreciation. That recommendation would have made the change to straight-line *mandatory* for *all* regulated companies whereas here, the change to liberalized depreciation with normalization is *only* when found to be appropriate by the regulatory agency. Moreover, the Commission's action would not even result in rate increases for all the companies subject to its regulation (many pipeline companies and electric utilities did not exercise the right of election), much less would it result in rate increases for all the companies in the several industries covered by Section 441. This is par-

ticularly so since, as noted in the House Committee report (see our main brief at p. 82), many regulated companies prefer to remain on flow-through for a variety of reasons.

B. The "Freeze" Bars Only Shifts To Faster Methods—Not Shifts To Slower Methods

With further regard to the "freeze", it is to be noted *first* that Congress did not intend to provide an absolute "freeze". Both the House Report (at p. 133) and the Senate Report (at p. 172) provide only for a freeze "in general".

Second, the "freeze" is *intended to operate only one way* and *to apply only to changes to faster methods of tax depreciation.* Companies on straight-line depreciation may not change to any form of liberalized depreciation, normalization or flow-through. Companies on normalization may not change to flow-through. By imposing such a "freeze", Congress was assured that there would be no increase in the revenue losses already being incurred as a result of the increasing trend toward the use of faster depreciation methods fostered by the various regulatory agencies.

Third, the "freeze" is *not intended to prohibit changes to slower methods of tax depreciation.* Companies on straight-line depreciation may not change from that method since that is the slowest method. Companies on normalization may change to straight-line depreciation (but not to flow-through) and companies on flow-through may change to either straight-line or normalization. By permitting such changes to slower methods of tax depreciation *with agency permission,* Congress made it possible for companies to remain on flow-through where their situation made it desirable for them to do so while, at the same time,

leaving the way open for the revenue losses to be reduced in other situations where a change to a slower method of tax depreciation is appropriate. It was on the basis of such anticipated changes to slower methods of tax depreciation that the House and Senate Committees both made their estimates as to the tax revenue *increases* which they expected to result from the proposed legislation (see our main brief at 52-53).

Fourth, a "freeze" prohibiting changes generally from liberalized depreciation with flow-through would destroy the flexibility needed to accommodate to changing conditions. For example, when the so-called "cross-over point" is reached, all will admit that the public interest is better served by changing from liberalized depreciation to a straight-line method of tax depreciation. (See our main brief fn. 24, pp. 52-53.) In addition, it would frustrate the Congressional purposes by preventing the reduction in tax revenue losses which would come about when a company on flow-through changes to a slower method of tax depreciation and by perpetuating the very type of tax revenue losses which the Act's legislative history plainly discloses was obnoxious to many of the responsible members of Congress. (See our main brief at p. 53.)

III.

THE COMMISSION'S ACTION IN PERMITTING TEXAS GAS TO CHANGE TO NORMALIZATION FOR ITS EXISTING AND NEW NON-EXPANSION PROPERTIES WAS WELL WITHIN ITS DISCRETION

A. The Commission's Action Is Based Upon Expertise

Much of respondents' attack upon the Commission's conclusion on the merits permitting Texas Gas to change to normalization with respect to its pre-1970 and post-1969 non-expansion properties is addressed to the Commission finding that, in light of the changed cir-

cumstances since *Alabama-Tennessee,*[8] the continued use by Texas Gas of liberalized depreciation for these properties would no longer result in a *tax savings* justifying a continued requirement that it use flow-through.

Whether the use of liberalized depreciation results in a *tax savings* or *tax deferral* in the circumstances of a particular case is precisely the type of question which the courts have consistently treated as a matter within the Commission's special competency and expertise. See our main brief at pp. 63-65. For example, in *Alabama-Tennessee,* where the Commission had found, that in the circumstances then prevailing, the use of liberalized depreciation resulted in a tax savings, the Fifth Circuit declined to set aside that finding on the ground that it went to

> "* * * the competency of the Commission to choose between competing accounting theories and competing economic guesses. We see nothing irrational in the Commission's choice (359 F.2d at 339)."

Respondents' contentions here (Memphis Br., pp. 24-33; N.Y. Comm. Br., pp. 36-47; APGA Br., pp. 11-12) constitute in large measure a reiteration of the reasons why, in their view, the Commission should have adopted a different "economic theory and guess". Since our main brief (at pp. 65-75) shows there is nothing irrational in the "economic theory" which the Commission adopted in reaching its conclusion, it follows that the Commission's finding here, that use of liberalized depreciation for Texas Gas' old property would result in a tax deferral, should be affirmed.

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[8] *Alabama-Tennessee Natural Gas Co.,* 31 FPC 208 (1964) *affirmed sub nom. Alabama-Tennessee Natural Gas Co.* v. *F.P.C.,* 359 F. 2d 318 (5th Cir. 1966) *cert. denied,* 385 U.S. 847 (1966).

B. The So-Called "Actual Taxes Paid" Principle Does Not Prevent Use of Normalization

The foregoing conclusion in no way is affected by respondents' additional argument that permitting Texas Gas to change to normalization with respect to its pre-1970 and post-1969 non-expansion properties violates a so-called "actual taxes paid" principle which, respondents urge, imposes a duty upon the Commission to limit the income taxes allowed for ratemaking purposes to only the income taxes actually paid. See Memphis Br., pp. 4-5, 15-22; N.Y. Comm. Br., pp. 29-35; APGA Br., pp. 10-11.

This argument goes much too far. Taken literally, respondents' argument would render the use of normalization unlawful *per se*. The basic concept underlying normalization is that the income taxes allowed for rate making purposes are to be computed upon the basis of straight-line depreciation while the actual taxes to be paid are to be computed upon the basis of liberalized depreciation. This means that, under normalization the taxes allowed are greater than the taxes actually paid in the early years of a company's operations, and lower than the taxes actually paid in later years. If respondents' arguments were to be applied, as urged by them, it would be improper to permit normalization in those early years. Yet, it is clear that Congress and the courts have accepted normalization as a permissible method of determining the income tax to be allowed in a regulated company's cost of service.

The facts are, moreover, that the so-called "actual taxes paid" principle is not as sweeping as urged by respondents and that in actuality that "principle" has not been invoked as a reason for rejecting normaliza-

tion. To the contrary, the courts have repeatedly recognized that there is no inconsistency between normalization and this so-called principle. For example, the *El Paso* case,[7] relied on so heavily by both the New York Commission (Br. pp. 31-32; see also p. 44) and Memphis (Br. p. 18), involved not only "the treatment of special tax savings from depreciation and intangible drilling expenses, realized by the pipeline company from its production activities" as urged both by Memphis (Br. p. 18) and the New York Commission (Br. p. 31), but also the treatment of income taxes where the FPC had permitted the company to use normalization. The Fifth Circuit expressly approved this latter Commission action, stating (*Id.* at 573-4):

> "* * * Other than the depreciation item, whatever federal income taxes were actually paid for the test year should be treated as part of the cost of service regardless of whether these taxes were less than would have been paid but for the depletion allowance and the deduction for intangible drilling expense. No theoretical amount not actually paid can be so included.
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> "The one exception, if it be an exception, is the treatment to be afforded the tax saving or deferral resulting from the use by the taxpayer of the declining balance method of depreciation of new equipment. In practical effect this works a tax deferral rather than a tax savings. * * * Therefore, we approve the Commission's treatment of the 'saving' resulting from using the declining balance method of depreciation for tax purposes but computing its taxes for rate making purposes on the straight line method of depreciation, placing

[7] *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F.2d 567 (5th Cir. 1960, *cert. denied sub nom. California* v. *F.P.C.*, 366 U.S. 912 (1961).

such 'savings' in a special reserve to be used to equalize tax payments in later years. These amounts can never represent added return to the company because of the restriction as to their use."

See also, *City of Lexington* v. *F.P.C.*, 295 F. 2d 109 (4th Cir., 1961), where the Fourth Circuit similarly accepted such use of normalization as not inconsistent with the so-called "actual taxes paid" principle (*Id.* at 116-118). See also cases cited in our main brief at pp. 63-65.

Respondents seek to "soft pedal" this facet of the *El Paso* opinion. Memphis mentions it only by way of footnote (Br. p. 18, fn. 6) and the New York Commission (Br. pp. 33-35) discusses it, along with *City of Lexington,* only as part of a brief summary of the history of the Commission's treatment of the problem. However, the undisputable fact is that in both of these cases, the Commission permitted the company involved to use normalization and the courts' approval of that Commission action fully recognized that it was not inconsistent with so-called "actual taxes paid" principle.[8]

Memphis (Br. p. 18, fn. 6) would further belittle this facet of *El Paso* by characterizing it as attributable

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[8] In *City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967), which Memphis cited as "again affirm[ing] the Commission's requirement of flow through" (Br. p. 19), the Court of Appeals expressly stated immediately following the excerpt quoted by Memphis (385 F.2d at 633):

> "However, as the Commission pointed out, in some cases normalization of tax deferrals is required lest future consumers be compelled to subsidize present consumers being served by the operations accruing tax liabilities."

to "the then current impression that the savings were only a deferral and that they represented an actual expense in the long run." However, all this proves is that the key question in dealing with the problem is the validity of the Commission's determination that liberalized depreciation results in a tax deferral. In other words, the governing criterion in reviewing the Commission's action relates to its finding that normalization resulted in a tax deferral—once that finding is held to be supported by substantial evidence, the "actual taxes paid" principle no longer stands in the way of permitting the company involved to use normalization. As Judge Leventhal phrased it in the *City of Chicago* case *supra* p. 637:

> "The Rule of Law does not forbid an agency from modifying its regulatory policy, and the courts have upheld policy revision many times.[26] Indeed one of the signal attributes of the administrative process is flexibility in reconsidering and reforming of policy. What is required by the Rule of Law is that agency policies and standards, whether or not modifications of previous policies, be reasonable and non-discriminatory, and flow rationally from findings that are reasonable inferences from substantial evidence."

[26] Citations omitted.

Since the Commission's finding here, that Texas Gas' use of liberalized depreciation for its pre-1970 and post-1969 non-expansion properties results in only a tax deferral, is "... reasonable and non-discriminatory, and flow[s] rationally from findings that are reasonable inferences from substantial evidence", it is well within its discretion and expertise (See our main brief at pp. 63-75). It, therefore, follows that the Commis-

sion's permission to Texas Gas to shift to normalization with respect to these properties does not violate the so-called "actual taxes paid" principle.

C. Funds Generated by the Use of Normalization for Expansion Properties Not Available To Offset Decline in Depreciation on Old Properties

Both Memphis (Br. pp. 24-30) and the New York Commission (Br. pp. 37-40) contend that Texas Gas does not require an increase in rates as a result of its election to discontinue the use of flow-through with respect to its new expansion property, because, the argument runs, with Texas Gas using liberalized depreciation for tax purposes on its new expansion property, the difference in taxes between the use of liberalized and straight-line depreciation on that property is available to offset the increased taxes on the old property.

This argument is completely specious. The entire concept of normalization is based upon the proposition that liberalized depreciation results in a tax deferral and that the difference is to be set aside in a reserve to be available in later years as the taxes increase. In the meantime, the funds are available to the taxpayer as an interest-free loan. To utilize that difference to offset the increased taxes on the old property will result in destroying the fundamental concept upon which normalization is based and, in effect, placing Texas Gas on flow-through with regard to its new expansion properties directly contrary to congressional intent in providing the election.

Moreover, under the Tax Reform Act of 1969, Congress, through the enactment of the special 180-day

election, has segregated property. Once the election has been exercised, the new expansion property must be considered separately from all other property. Thus, the use of normalization with respect to the new expansion property automatically earmarks the additional dollars and places them in a reserve for future higher taxes relating to that property. Consequently, they are not available to offset the higher tax expense resulting from the decline in depreciation with respect to the old properties.

Memphis and the New York Commission seek to answer the foregoing argument by further contending that there is no need to place these funds in a reserve, and that although the Commission's Uniform System of Accounts provides for such a reserve, the reserve is not so restricted and, in any case, there is no need for any such restriction. In so urging, respondents disregard the express provisions of Section 441 (a)(3)(G) of the Tax Reform Act of 1969. That section defines normalization, generally, as follows:

(i) the taxpayer must use the same method of depreciation (*i.e.*, straight line) to compute its tax expense and depreciation expense for ratemaking as well as book purposes. This is being done by Texas Gas.

(ii) if a different method is used for computing its actual taxes (*i.e.*, liberalized depreciation), then "... the taxpayer must *make adjustments to a reserve* to reflect the *deferral* of taxes resulting from the use of such different methods of depreciation." This is being done by Texas Gas.

Thus, respondents' argument that the funds generated through the normalization of new expansion property will be available to offset the increased taxes on the

old property is completely undercut by the clear language of the Tax Reform Act and flies in the teeth of the explicit Congressional recognition that an essential part of normalization is the creation of a reserve to be available for the future payment of presently deferred taxes.

Respondents' arguments are invalid for the further reason that since the Commission requires that the reserve for future taxes is to be deducted from a utility's rate base, the only way that a utility can continue to earn its allowed return is either (1) by adding to its rate base or utility plant, an amount at least equal to the additions in the reserve for future taxes or (2) by reducing its utility capital by a like amount through retirements, prepayments, or payment of dividends. Thus, it is apparent that the reserve dollars cannot be used for payment of higher taxes on old plant. Otherwise, the utility's return would be improperly reduced by that amount.

D. The Effective Date Used by the Commission Was Proper

Finally, Memphis argues (Br. pp. 32-33) that even if the Court finds against it on all other matters, the Commission nevertheless erred in permitting Texas Gas to change to normalization for its pre-1970 and post-1969 non-expansion property prior to January 1, 1971, because, according to Memphis, the election did not become effective as to the new expansion property until the first taxable year beginning after December 31, 1970. This claim is patently an after-thought, not having been raised in Memphis' application for rehearing; accordingly, consideration of this claim by the

Court is precluded under Section 19(b) of the Natural Gas Act.[9]

In any case, Memphis' claim has no merit. The Congressional purpose in thus postponing the effective date of the election was:

> "to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, . . ." (S. Rep. No. 91-552 at p. 173, Texas Gas main brief App. 84)

In other words, the purpose of the postponement was to protect the regulated company from having to put the election into effect before it made the adjustments in rates required in order to avoid any resulting adverse financial impact. Since the election had to be exercised within 180 days of the enactment of the Tax Reform Act, many utilities could have been confronted —absent such postponement of the effective date of the election—with an immediate increase in revenue requirements associated with the change from flow-through to either normalization or straight-line depreciation for tax purposes without a corresponding increase in rates.

Here, the Commission's action had no such adverse impact upon Texas Gas. When Texas Gas exercised its right of election, it had a rate case pending before

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[9] Section 19(b) of the Natural Gas Act specifically provides that "[n]o objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do."

the Commission in which the proposed rates were at a level sufficient to accommodate normalization. Since, therefore, Texas Gas did not need any additional time to change its books and rates to reflect the use of normalization, the Commission's action herein was in accord with the congressional purposes.

CONCLUSION

For the foregoing reasons, as well as those set forth in our main brief, it is respectfully submitted that the judgment of the Court of Appeals should be reversed with directions to affirm the Commission's Opinions No. 578 and 578-A.

Respectfully submitted,

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(Slip Opinion)

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

FEDERAL POWER COMMISSION *v.* MEMPHIS LIGHT, GAS & WATER DIVISION ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 72-486. Argued March 27, 1973—Decided May 7, 1973*

Section 441 of the Tax Reform Act of 1969 does not deprive the Federal Power Commission of the authority to permit a utility that is subject to its jurisdiction under the Natural Gas Act to change the depreciation method that it uses for purposes of rate-making from accelerated depreciation with "flow through" of the utility's tax savings to customers to accelerated depreciation with normalization (where the income tax expense allowed in the cost of service is computed on a straight-line depreciation basis) with respect to pre-1970 property as well as replacement property. Pp. 7-16.

— U. S. App. D. C. —, 462 F. 2d 853, reversed.

DOUGLAS, J., delivered the opinion for a unanimous Court.

*Together with No. 72-488, *Texas Gas Transmission Corp.* v. *Memphis Light, Gas & Water Division et al.*, also on certiorari to the same court.

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D.C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

Nos. 72-486 AND 72-488

Federal Power Commission, Petitioner,
72-486 v.
Memphis Light, Gas and Water Division, et al.

Texas Gas Transmission Corporation, Petitioner,
72-488 v.
Memphis Light, Gas and Water Division, et al.

On Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit.

[May 7, 1973]

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

We granted certiorari in these cases to determine whether § 441 of the Tax Reform Act of 1969, 26 U. S. C. § 167 (*l*), circumscribes the authority of the Federal Power Commission under the Natural Gas Act, 15 U. S. C. § 717 *et seq.*, to permit a regulated utility to change its method of computing depreciation for rate-making purposes from "flow-through" to "normalization" with respect to property acquired prior to 1970 as well as "replacement" property.

Since the resolution of this issue depends largely on the background and history of § 441 and the Commission's regulatory powers, a brief review is in order at the outset. Section 167 of the Internal Revenue Code authorised taxpayers, including regulated utilities, to use accelerated or liberalised depreciation in calculating their

federal income taxes.[2] The Federal Power Commission retained jurisdiction to prescribe the depreciation method to be used by regulated utilities in calculating their federal income tax expense for ratemaking purposes.[3] Initially, the Commission required utilities to compute their cost of service, which includes federal income taxes, as if they were using straight-line depreciation. This method, referred to as "normalization," was designed to avoid giving the present customers of a utility the benefits of tax deferral attributable to accelerated depreciation. If a utility used accelerated depreciation in determining its actual tax liability, the difference between the taxes actually paid and the higher taxes reflected as a cost of service for ratemaking purposes was required to be placed in a deferred tax reserve account. See *Amere Gas Utilities Co.*, 15 F. P. C. 760.

It soon became apparent that accelerated depreciation in practice resulted in permanent tax savings. Because most utilities had growing or at least stable plant invest-

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[1] Section 167 (a) provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of qualified property. Section 167 (b) defines "reasonable allowance" to include an allowance computed under the declining balance method and the sum of the years-digits methods, as well as the straight line method. Under the declining balance and sum of the years-digits method, both commonly referred to as accelerated or liberalized depreciation methods, depreciation allowances in the early years are higher than under the straight line method, but steadily decrease over the useful life of the asset. Under the straight line method, the depreciation allowance for an asset remains equal over its useful life.

[2] Federal income taxes are properly included as an expense under the cost of service ratemaking utilized by the Commission in the regulation of rates for sales of natural gas subject to its jurisdiction under the Natural Gas Act, 15 U. S. C. § 717 *et seq.* See *FPC* v. *United Gas Pipe Line Co.*, 386 U. S. 237, 243.

ments, the depreciation allowances from additional and replacement equipment offset the declining depreciation allowance on existing property. Accordingly, the Commission required utilities using accelerated depreciation for tax purposes to use the same method for calculating their cost of service and, thus, to "flow-through" any tax savings to their customers. *Alabama-Tennessee Natural Gas Co.*, 31 F. P. C. 208, aff'd *sub nom. Alabama Tennessee Natural Gas Co.* v. *FPC*, 359 F. 2d 318 (CA5). Subsequently, the Commission decided that it would impute the use of accelerated depreciation for ratemaking purposes regardless of the method used for computing actual taxes. *Midwestern Gas Transmission Co.*, 36 F. P. C. 61, aff'd *sub nom. Midwestern Gas Transmission Co.* v. *FPC*, 388 F. 2d 444 (CA7).

When the House and Senate considered tax reform legislation in 1969, both were concerned with the loss of tax revenues that stemmed from the combined effect of accelerated depreciation for computing federal taxes (leading to higher deductions) and flow-through for fixing rates (leading to lower rates and thus lower gross revenues).[3] Section 441 of the Tax Reform Act, which added § 167 (*l*) to the Internal Revenue Code, was designed in general to "freeze" existing depreciation practices.[4] As passed by the House, § 441 would have established three rules with respect to existing depreciable property:[5]

> "(1) If straight-line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

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[3] See H. R. Rep. No. 91–413 (pt. 1), 91st Cong., 1st Sess., 131–132; S. Rep. No. 91–552, 91st Cong., 1st Sess., 172.

[4] See H. R. Rep. No. 91–413, *supra*, n. 3, at 132–133; S. Rep. No. 91–552, *supra*, n. 3, at 172.

[5] H. R. Rep. No. 91–413, *supra*, n. 3, at 133.

"(2) If the taxpayer is taking accelerated depreciation and is 'normalizing' its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

"(3) If the taxpayer is taking accelerated depreciation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property."

The Senate bill as passed was similar to that of the House, except that utilities on flow-through were given the right to elect within 180 days "to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or . . . with the permission of the regulatory agency to shift to the normalization method . . . ."[6] This election was to apply both to new and existing property. In conference, however, it was agreed that this right of election would apply only to property acquired by the utility after 1969 to expand its facilities.[7]

Thus, as added to the Internal Revenue Code in 1969, § 167 (l) distinguishes between two basic types of "public utility property":[8] "pre-1970 property," which is

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[6] S. Rep. No. 91-552, *supra*, n. 3, at 173.

[7] See H. Conf. Rep. No. 91-782, 91st Cong., 1st Sess., 313.

[8] Section 167 (*l*) (3) (A) provides:

"The term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

"(i) electrical energy, water, or sewage disposal services,

"(ii) gas or steam through a local distribution system,

"(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U. S. C. 701), or

"(iv) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency

property acquired by the taxpayer before January 1, 1970 (§ 167 (*l*)(3)(B)), and all other property, referred to as "post-1969 property" (§ 167 (*l*)(3)(C)). A further distinction is drawn between post-1969 property "which increases the productive or operational capacity of the taxpayer" (expansion property) and post-1969 property which merely replaces existing property (§ 167 (*l*)(4)(A)). With respect to pre-1970 property, a utility may use (1) straight-line depreciation, (2) the method used prior to August 1969 if it also employs normalization, or (3) accelerated depreciation with flow-through, but only if that method was used prior to August 1969 (§ 167 (*l*)(1)). With respect to post-1969 property, a utility may use (1) straight-line depreciation, (2) accelerated depreciation with normalization, or (3) accelerated depreciation with flow-through if the utility used flow-through prior to August 1969 (§ 167 (*l*)(2)). In addition, under § 167 (*l*)(4)(A), a utility may elect to abandon accelerated depreciation with flow-through with respect to post-1969 expansion property.

The proceedings in issue here involve Texas Gas Transmission Corporation, the operator of a major interstate pipeline system certificated by the Federal Power Commission. Although Texas Gas utilized accelerated depreciation with flow-through prior to the adoption of the Tax Reform Act, it filed a proposed rate increase with the Commission on June 27, 1969, based upon "the proposed discontinuance of the use of liberalized depreciation and the reversion to a straight-line method of tax depreciation." After § 167 (*l*) was enacted, Texas Gas advised the Commission that it intended to exercise the election provided in § 167(*l*)(4)(A) and sought permission to use accelerated depreciation with normalization

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or instrumentality of the United States, or by a public service or public utility commissioner or other similar body of any State or political subdivision thereof."

with respect to its post-1969 expansion property.[5] It also sought assurance, before it made the election, that it would be able to change from flow-through to straight-line or, preferably, accelerated depreciation with normalization with respect to its pre-1970 property and post-1969 replacement property.

The Commission, holding that its authority "to determine whether a company may effect such a change is not diminished" under the Tax Reform Act, permitted Texas Gas to change from flow-through to normalization for ratemaking purposes. Order No. 578, — F. P. C. —, rehearing denied, — F. P. C. —.[6] The Commission reasoned that the basis of its decisions in *Alabama-Tennessee* and *Midwestern* would no longer be applicable if Texas Gas were to switch to normalization with respect to post-1969 expansion property. In that event, the tax savings resulting from the deferral attributable to ac-

[5] In Order No. 404, 42 F. P. C. 740, rehearing denied, 44 F. P. C. 16, the Commission announced that as a general policy it would permit utilities making the election under § 167 (l)(4)(A) to use accelerated depreciation with normalization with respect to their expansion property. The Court of Appeals, in the same decision under review here, affirmed this order. — F. 2d —. That part of the court's decision is not before us.

[6] The Commission's order reads:

"(A) In the computation of its Federal Income Tax allowance for ratemaking purposes as well as for accounting purposes, Texas Gas is permitted to use liberalized depreciation with normalization with respect to its property other than that subject to election under Section 167 (l)(4)(A) of the Internal Revenue Code as amended by Section 441 of the Tax Reform Act of 1969. Such election applies to property constructed or acquired on or after January 1, 1970, to the extent it increases the productive or operational capacity of the company and does not represent the replacement of existing capacity. Texas Gas may reflect any such change in its rates, as well as any change in costs arising from its proposed election. In computing its cost of service for ratemaking purposes balances in Account 282 [deferred tax reserve account] should continue to be deducted from the rate base."

celerated depreciation would not be permanent. Rather, if Texas Gas were required to continue flow-through for all but its new expansion property, it would be faced with a steadily increasing cost of service which would necessitate repeated rate increases. Under these circumstances, the Commission concluded: "Texas Gas is correct in contending that normalization in computing the tax allowance for rate purposes with respect to its pre-1970 facilities offers more hope for stability of rates for its customers and more assurance that the company can earn its fair rate of return without future rate increases. Further benefits of normalization are that it will improve the company's before tax coverage of interest, thereby enhancing the quality of its securities, and it will help alleviate present day cash shortages." *Id.*, at —.

The Court of Appeals, on petitions for review, reversed the Commission's order.[11] 462 F. 2d 853, rehearing denied, 462 F. 2d 865. Although the court recognized that the version of the Tax Reform Act passed by the House would have supported the Commission's order, it held that the limited nature of the election provision as finally passed deprived the Commission of authority to permit regulated utilities to abandon flow-through with respect to their existing and replacement property. We reverse and remand to the Court of Appeals for further proceedings consistent with this opinion.

The present cases concern solely the depreciation methods used by utilities in calculating their federal income tax expenses for ratemaking purposes.

[11] Memphis Light, Gas and Water Division, a municipally owned distributor of natural gas and a city-gate customer of Texas Gas, and the Public Service Commission of the State of New York petitioned the Court of Appeals for review of the Commission's Order No. 578. Each had filed an application for rehearing before the Commission which was denied in Order No. 578-A. Both the Federal Power Commission (in No. 72-486) and Texas Gas (in No. 72-488) petitioned this Court for a writ of certiorari.

In § 441 of the Tax Reform Act of 1969, Congress dealt primarily with a revenue measure under the tax laws and only indirectly with the regulatory power of the Commission under the Natural Gas Act. We have had before us on numerous occasions cases arising under the Natural Gas Act. In the early case of *Federal Power Commission v. Hope Natural Gas Co.*, 320 U. S. 591, we emphasized two aspects of the power of the Commission to fix "just and reasonable" rates under 15 U. S. C. § 717. First, was the desire "to protect consumers against exploitation," 320 U. S., at 610, and second was the aim to promote the "financial integrity" of the natural gas companies as measured not only by revenues sufficient to recover operating expenses and capital costs, *id.*, at 603, but also by revenues "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Ibid.* We mention those matters because (1) the treatment of depreciation bears on rates and (2) there is no indication in the legislative history of this tax measure that Congress desired to modify, as respects the precise issue involved here, the broad discretion of the Commission delineated in *Hope Natural Gas* and in other rate cases.

Under § 4 (e) of the Natural Gas Act, 15 U. S. C. § 717c (e), all rates and charges made by a natural gas company subject to the Commission's jurisdiction must be "just and reasonable." Section 4 (e), 15 U. S. C. § 717c (e), sets forth the procedures whereby the Commission can determine whether a proposed rate schedule is lawful, and § 5, 15 U. S. C. § 717d, gives the Commission certain powers to fix rates and charges. Finally, under § 9 (e), 15 U. S. C. § 717h, the Commission may "require natural-gas companies to carry proper and adequate depreciation and amortization accounts in accordance with such rules, regulations, and forms of

account as the Commission may prescribe." In *FPC* v. *United Gas Pipe Line Co.*, 386 U. S. 237, 243, the Court stated:

> "One of [the Commission's] statutory duties is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment. Cost of service is therefore a major focus of inquiry. Normally included as a cost of service is a proper allowance for taxes, including federal income taxes. The determination of this allowance, as a general proposition, is obviously within the jurisdiction of the Commission."

The lower courts have allowed the Commission broad discretion in determining proper depreciation methods for ratemaking purposes. See, *e. g.*, *Alabama-Tennessee Natural Gas Co.* v. *FPC*, *supra*; *Midwestern Gas Transmission Co.* v. *FPC*, *supra*.

Section 167 (*l*), to be sure, does not leave this discretion untouched. For example, a utility using straight-line depreciation with respect to its pre-1970 property could not switch to accelerated depreciation, nor could a utility be required to switch to flow-through with respect to pre-1970 property. See § 167 (*l*)(1). But § 167 (*l*) on its face does not preclude the Commission from exercising its statutory powers to permit a utility to abandon flow-through. Section 167(*l*)(1)(B) provides that "[i]n the case of any pre-1970 public utility property, the taxpayer *may* use the applicable 1968 method for such property if—(i) the taxpayer used a flow-through method of accounting" prior to August 1969. (Emphasis added.)

The Court of Appeals, however, found error in the Commission's action based on its detailed and considered analysis of the legislative history of § 167 (*l*). It con-

cluded that "the final version of the bill limits the applicability of the right of election to post-1969 expansion (nonreplacement) property alone." 462 F. 2d 858, 863. It reasoned as follows: At the House stage the action of the Commission would have been justified to switch to normalization because, as already noted, the House Report stated: [12]

"Your committee's bill provides that, in the case of *existing* property, the following rules are to apply:

"(1) If straight line depreciation is presently being taken, then no faster depreciation is to be permitted as to that property.

"(2) If the taxpayer is taking accelerated depreciation and is 'normalizing' its deferred taxes, then it must go to the straight line method unless it continues to normalize as to that property.

"(3) If the taxpayer is taking accelerated depreciation and is flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, *unless the appropriate regulatory agency permits a change as to that property.*" (Emphasis added.)

The word "existing" property as used in that Report included "replacement" property in the mind of the Court of Appeals.

The Senate version of the bill [13] would have permitted Texas Gas to shift from liberalized depreciation with

[12] H. R. Rep. No. 91-413, *supra*, n. 3, at 132–133.

[13] S. Rep. No. 91-552, *supra*, n. 3, at 173–174.

"The (Senate) committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days after the date of enactment of the bill for a utility covered by this provision to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency,

flow-through either to straight-line depreciation or with the Commission's approval to liberalized depreciation with normalization. 462 F. 2d, at 882.

The Court of Appeals, however, concluded that because the right of election was restricted while the bill was in conference to apply only to post-1969 expansion property, the Commission could not permit a utility to change its method with respect to existing or replacement property. *Ibid.* It relied on the following four paragraphs from the Conference Report:[14]

> "The House bill provides that in the case of certain regulated industries (the furnishing or sale of . . . gas through a local distribution system, . . . and transportation of gas by pipeline) a taxpayer is *not permitted* to use accelerated depreciation *unless it 'normalizes'* the current income tax reduction resulting from the use of such accelerated depreciation. . . .
>
> *"This rule is not to apply in the case of a taxpayer that is at present flowing through the tax reduction to earnings for purposes of computing its allowable expenses on its regulated books of account.* Also, if the taxpayer is now using straight line depreciation as to any public utility property it may not change to accelerated depreciation as to that property.

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or permit it with the permission of the regulatory agency to shift to the normalization method (that is, come under general rules of the bill).

"This election applies both as to new and existing property . . . . Since the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), the agency would not be able to impute the use of accelerated depreciation with flow-through." (Emphasis added.)

[14] H. Conf. Rep. No. 91-782, *supra*, n. 7, at 312-313.

"The Senate amendments make the following changes in the House bill: . . . (d) an election is permitted to be made within 180 days after the date of enactment by a company at present on flow-through to come under the rules of the bill; . . .

"The conference substitute (sec. 441 of the substitute and sec. 167 (l) of the code) follows the Senate amendment except that the special provision referred to in (c) above is stricken and the 180-day election (item (d), above) is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flowthrough method is to be available only to the extent the new property increases the productive or operational capacity of the company." (Emphasis added.)

From these four paragraphs the Court of Appeals concluded that the second paragraph of the Conference Report prohibits Texas Gas from abandoning liberalized depreciation with flow-through and that the right of election was restricted to post-1969 expansion property only.

The second paragraph, however, as we read it, when it uses the words "This rule" refers not to the final bill but the initial House bill. That initial bill, as summarized in the House Report, as already noted,[23] had somewhat different provisions for depreciation. The first paragraph of the quotation from the Conference Report in our view summarized the House's proposed second rule. The words "This rule" in the second paragraph therefore refer to the House's proposed second rule.[24]

[23] H. R. Rep. No. 91-413, supra, n. 3, at 123.

[24] The second rule, as noted, provided, "If the taxpayer is taking accelerated depreciation and is 'normalizing' its deferred taxes, then

Only the third paragraph of the excerpt reached the changes made by the Senate. Only the fourth paragraph resolved the differences between the two bills. There is nothing in either the third or the fourth paragraph to indicate that the election authorized by the Conference Report was to limit or replace the three general rules proposed by the House, the third House proposed rule [17] authorizing precisely what the Commission allowed in this case. The second paragraph, read in the context of the Conference Report, does not state that the Commission lacks authority to permit a company on flow-though to abandon it with respect to existing property. It only states that a company on flow-through may remain on flow-through. Thus, it is solely a limitation on the requirement that a company must normalize if it wants to continue accelerated depreciation with respect to pre-1970 property. This is entirely consistent with the structure of § 167 (*l*)(1).

Nor is the extension of the 180-day election to post-1969 expansion property a limiting factor. The "reasonable" allowance for depreciation of post-1969 property as used in § 167 (*l*)(2) includes in subparagraph (C) "the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period." But § 167 (*l*)(4)(A) provides that where the

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it must go to the straight line method unless it continues to normalize as to that property." *Ibid.*

[17] The third rule, as noted, provided, "If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer must continue to do so, unless the appropriate regulatory agency permits a change as to that property." *Ibid.*

taxpayer makes an election within the 180-day period, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property "to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer" and does not represent "the replacement of existing capacity."

Thus the Act recognizes ways for a utility to abandon flow-through with respect to existing property. A utility cannot do so on its own; the overriding authority is in the Federal Power Commission. The staff of the Joint Committee on Internal Revenue Taxation prepared a General Explanation of this tax measure[10] in which it stated:

> "If the taxpayer was taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes as of August 1, 1969, then the taxpayer would continue to do so (except for a special election procedure discussed below), unless the appropriate regulatory agency permits a change as to that property."

This document goes on to state[11] that as respects new property a utility on flow-through must remain on flow-through "unless the regulatory agency permits it to change (or unless the election below applies)."

This document provides a compelling contemporary indication that the Federal Power Commission was not deprived of its authority to permit abandonment of flow-through, even though utilities had the right not to have flow-through apply to their expansion property.

The Court of Appeals relied on comments both in the

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[10] General explanation of the Tax Reform Act of 1969, H. R. 13270, 91st Cong., at 151.

[11] *Ibid.*

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House[30] and in the Senate[31] Reports of the desire of Congress to "freeze" the current practices relating to depreciation especially as respects "the more flourishing utility industries."[32]

As we read the Reports the purpose was to forestall switches to faster methods of depreciation, to guard against widespread rate increases, and to avoid putting some utilities at a competitive disadvantage. But the "freeze" was not put in absolute terms. Shifts from straight-line to accelerated depreciation were outlawed, as were shifts from normalization to flow-through on existing property. We find no trace of a suggestion that the Federal Power Commission was denied authority to determine whether on particular facts the abandonment of flow-through by a utility within the parameter of the Tax Reform Act of 1969 would be in the public interest as envisaged by the Natural Gas Act, even though it might increase rates. The "freeze" certainly was designed to cover changes to faster methods of tax depreciation but not changes to slower methods of tax depreciation that the Federal Power Commission might permit.

The Court of Appeals sustained the Commission as respects the post-1969 expansion property of Texas Gas, and reversed it as respects the pre-1970 and post-1969 nonexpansion property. The Court of Appeals did not reach the validity of the Commission's order, assuming the Commission was correct in its reading of the Tax Reform Act of 1969, as we think it was. The Court of Appeals did, however, state that § 167 (*l*) "should not be construed to prevent" the Commission from finding in "extraordinary circumstances" that consumer interests

[30] H. R. Rep. No. 91-413, *supra*, n. 3, at 132-133.

[31] S. Rep. No. 91-552, *supra*, at 172.

[32] *Ibid.*

"would be furthered by permitting the abandonment of flow-through." But it added: "It is clear, however, that such consumer interests would not be furthered by permitting Texas Gas to abandon flow-through in the circumstances presented by the case at bar." 402 F. 2d, at 885. The Commission in its petition for certiorari states that in connection with the main question raised it would argue, if the petition were granted, that its decision on the merits was correct in all respects. And in its brief on the merits it urges us to decide the merits. But by statute* the Court of Appeals is the tribunal where review must be sought; and we remand the cases to it for proceedings consistent with this opinion. We note in closing, however, that the judgment of the Court of Appeals is reversed *in toto*. Its holding that the consumer interests were not furthered by the Commission's action is short of the application of the appropriate standard for review. As already noted, under *Hope Natural Gas* rates are "just and reasonable" only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong.

Reversed.

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*Section 19 (b) of the Natural Gas Act, 15 U. S. C. § 717r (b), provides:

"Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the court of appeals of the United States for any circuit wherein the natural gas company to which the order relates is located or has its principal place of business, or in United States Court of Appeals for the District of Columbia . . . ."